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In the Supreme Court of the United States

OCTOBER TERM, 1982

PHILIP D. FARMAR AND MARIAN J. FARMAR
and
A. A. SUGG AND MARY S. SUGG,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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November 5, 1982

QUESTION PRESENTED FOR REVIEW

Section 613 of the Internal Revenue Code of 1954 (26 U.S.C.) allows percentage depletion deductions with respect to gross income from oil and gas interests. Since its enactment in 1975, Section 613A has placed a maximum limit on such percentage depletion.

The question presented is whether the Petitioners, who assigned oil and gas leases partly in consideration for lease bonuses, are entitled to percentage depletion with respect to such lease bonuses or whether the maximum limitation imposed by Section 613A *sub silentio* has overruled the long-standing decisions of this Court which have interpreted Section 613 to allow percentage depletion on oil and gas lease bonuses.

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UNITED STATES OF AMERICA,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Petitioners, Philip D. Farmar and Marian J. Farmar and A. A. and Mary S. Sugg, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in this proceeding on September 22, 1982.

OPINION BELOW

The opinion of the court of Claims (Appendix A, *infra*, la-16a) is not yet reported.

JURISDICTION

The opinion of the Court of Claims was filed on September 22, 1982, and judgment was entered on that day. The jurisdiction of this Court is invoked under 28 U.S.C. 1255.

STATUTE INVOLVED

The pertinent parts of Sections 611, 613 and 613A of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in Appendix E, *infra*, 90a-94a.

STATEMENT

The relevant facts are undisputed and there are no material distinctions between the two cases consolidated in the Court of Claims decision.

Petitioners are mineral owners of certain lands in Texas. During 1975, Petitioners leased their oil and gas mineral rights to certain lessees interested in oil and gas exploration, reserving royalties and receiving cash payments ("bonuses") as consideration for the leasing transactions. The bonuses were payable to Petitioners in installments: one portion was payable in 1975 and other portions were payable in each of the years 1976, 1977, 1978, and 1979. The portion of the bonuses payable in 1976 were paid in January of that year and later in 1976 oil and gas was discovered on the lands leased by Petitioners. Oil and gas from the properties leased by Petitioners was produced in substantial quantities during 1976 and subsequently (Appendix A, *infra*, 2a).

In their joint federal income tax returns for the year 1976, Petitioners claimed percentage depletion deductions with respect to the bonuses received in that year. The Internal Revenue Service examined such federal income tax returns and on February 10, 1978 assessed a deficiency in federal income taxes against Petitioners solely attributable to the disallowance of the claimed percentage depletion deductions on the bonuses. Petitioners paid the asserted deficiencies and filed claims for refund with the District Director of the Internal Revenue Service, Dallas, Texas, claiming that they were entitled to percentage depletion deductions under the provisions of Sections 611, 613 and 613A of the Internal Revenue Code of 1954. The Internal Revenue Service denied the claims for refund, whereupon Petitioners commenced this refund suit in the

United States Court of Claims (Appendix A, *infra*). Since the facts were undisputed, both Petitioners and the United States moved for summary judgment; the Court of Claims granted the motion of the United States and denied Petitioners' motion, thereby holding that percentage depletion deductions are not allowable with respect to oil and gas lease bonuses. (Appendix A, *infra*).

REASONS FOR GRANTING THE PETITION

1.a. In holding that percentage depletion is not allowable on oil and gas lease bonuses, the decision below conflicts with *Engle* v. *Commissioner of Internal Revenue*, 677 F.2d 594 (7th Cir. 1982) (Appendix B, *infra*, 17a-31a). In *Engle*, the Seventh Circuit held that percentage depletion is allowable under Sections 613 and 613A on advance royalties paid with respect to an oil and gas lease, even when no production of oil or gas occurred during the year when the advance royalties were paid. Since lease bonuses have always been deemed advance royalties for purposes of federal income tax under the holdings of this Court, the decision of the Seventh Circuit in *Engle* squarely conflicts with the Court of Claims holding below.

b. In its opinion below, the Court of Claims expressed the view that its holding may not necessarily be inconsistent with the holding of *Engle* because its opinion dealt with lease bonuses and *Engle* was concerned with advance royalties. That view is not correct because under the decisions of this Court advance royalties and lease bonuses have always been treated the same and accorded identical tax treatment. *See Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934); *Murphy Oil Co.* v. *Burnet*, 287 U.S. 299, 302 (1932); *Burnet* v. *Harmel*, 287 U.S. 103, 111-112 (1932). Furthermore, when the Tax Court was considering the advance royalties in *Engle*, 76 T.C. 915 (1981) (Appendix C, *infra*), the Tax Court was also considering a companion case dealing with bonuses on oil and gas leases, *Glass* v. *Commissioner*, 76 T.C. 949 (1981). The Tax Court correctly recognized that the same legal issue was involved in the advance royalty case and in the lease bonus case (Appendix D, *infra*, 81a- 84a).

c. The Commissioner of Internal Revenue has petitioned this Court for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit in the *Engle* case. In that petition, the Commissioner of Internal Revenue correctly points out that the decision of the Seventh Circuit in *Engle* and the decision of the Court of Claims below are in direct conflict. The Commissioner also stated that bonuses for oil and gas leases have always been deemed advance royalties for income tax purposes under the decisions of this Court and that advance royalties and lease bonuses have always been accorded identical income tax treatment. Petitioners agree with both of these conclusions.

Nationwide uniformity in the application of federal tax law is a matter of great importance. This Court should act to resolve the direct conflict between the decisions of the Seventh Circuit and the Court of Claims.

2. The Commissioner of Internal Revenue further points out in his petition to this Court in *Engle* the importance of the question presented to the administration of the revenue laws:

> We are advised by the Internal Revenue Service that there are presently 11 cases pending administratively involving advance royalties or lease bonuses with more than $2 million at stake, and 7 cases docketed in the Tax Court with more than $500,000 at issue. Moreover, the payment of advance royalties and lease bonuses is a common occurrence in oil and gas lease transactions. Hence, it is expected that the conflict of decisions will result in the filing of a substantial number of claims for refund. A resolution by this Court will put the matter to rest and avoid further inconclusive litigation.

Petition For a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit, *Commissioner of Internal Revenue* v. *Fred L. and Mary A. Engle* (filed October, 1982), at pages 5-6. Petitioners agree with this conclusion. Indeed, since bonuses are paid in the vast majority of all leasing transactions, hundreds of thousands of lessors are affected by this issue and unless this Court resolves the proper tax treatment with regard to such bonuses, continuous further litigation will result.

3.a. It is undisputed that Sections 613 and 613A allow percentage depletion on oil and gas only if the depletion deductions are "with respect to production." Under the settled law prior to the enactment of Section 613A, a bonus for an oil and gas lease has always been treated as an advance royalty for all purposes of the federal income tax system. *Burnet* v. *Harmel, supra.* Because a bonus is equivalent to a royalty, the tax treatment must be the same for both types of income and this Court held that percentage depletion deductions are allowable with respect to the bonus even if no wells are drilled and no actual production occurs during the year of the bonus payment. *Herring* v. *Commissioner, supra.*

However, such depletion deductions are only tentatively allowed. The deductions are subject to the contingency that actual extraction or production will occur in the future: if there is no subsequent production of oil or gas, the previously-allowed depletion deductions must be restored to income. *Douglas* v. *Commissioner,* 322 U.S. 275 (1944). Thus, prior to the enactment of Section 613A, percentage depletion on lease bonuses and advance royalties was absolutely dependent upon "production" because only then could the taxpayer retain the percentage depletion allowance without restoring it to income.

b. The enactment of Section 613A as part of the Tax Reduction Act of 1975 did not change the above-described law. Section 613A repealed oil and gas percentage depletion for integrated oil companies but continued oil and gas percentage depletion for independent domestic producers and royalty owners. This is accomplished by Section 613A first reinstating Section 613 as the enabling statute for oil and gas percentage depletion for independent producers and royalty owners. Section 613A then imposes a maximum limitation with respect to the amount of the percentage depletion allowance based on volumes of production by providing that percentage depletion "shall be computed in accordance with Section 613 with respect to *** so much of taxpayer's average daily production" of domestic crude oil and natural gas as does not exceed a specified depletable quantity.

See Tax Reduction Act of 1975, Pub. L. No. 94-12 Section 501(a) and (b)(1), 89 Stat. 47 and 53.

Since a bonus is a royalty paid in advance, the tax treatment of the bonus must be equivalent to an additional royalty earned throughout the life of the lease. See *Harmel* and *Herring, supra.* The proper way to harmonize Section 613 (based on dollars of gross income) with the maximum limitation of Section 613A (based on volumes of oil or gas production) is simply to apply Section 613 to the bonus income and to apply the maximum limits of Section 613A to the additional royalty production to which the bonus is equivalent.

c. The conflict in the views of the Seventh Circuit in *Engle* and the Court of Claims is not whether Section 613A requires that oil and gas percentage depletion is allowable only "with respect to production." Both Courts agreed that Section 613A does contain that requirement. The conflict between the courts centers on whether Section 613A was intended by Congress to create a *prerequisite* of oil or gas production before percentage depletion is allowable (the Court of Claims view) or whether Congress intended Section 613A to be a *maximum limitation* upon the amount of percentage depletion claimed by the taxpayer, which maximum limitation was phrased in terms of oil and gas production (the Seventh Circuit view). In *Engle* the Seventh Circuit found that Section 613A could reasonably be interpreted either way and that there was no pertinent legislative history to indicate Congressional intent. Therefore, the Seventh Circuit held that the settled law as developed by this Court in *Harmel, Herring,* and *Douglas, supra,* was not overruled *sub silentio* by some vaguely-perceived penumbra of the newly-enacted statute. Accord: Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction,* 57J. of Taxation 230 (1982); Note: 56 Tulane L. Rev. 1082 (1982).

Congress is presumed to know the prior construction of an original act or code (i.e., the interpretation given to Section 613 by this Court under *Harmel, Herring,* and *Douglas*). *Reed* v. *The Yaka,* 373 U.S. 410 (1963). Thus, Congress knew that percentage

depletion has always been allowable with respect to oil and gas lease bonuses and advance royalties and also knew that actual extraction or production of oil and gas at a subsequent time was necessary for the taxpayer to retain such percentage depletion deductions without restoring them to income. Since oil and gas percentage depletion on bonuses and advance royalties has always been dependent upon being "with respect to production," the words of Section 613A demonstrate that that provision is intended only as a maximum limit on the amount of percentage depletion to be claimed by a taxpayer in each taxable year (as the Seventh Circuit has held in *Engle*) and not as a prerequisite to the allowance of such percentage depletion (as the Court of Claims has held in its opinion below). In the absence of any evidence of contrary Congressional intent, there is no basis for concluding that Congress by providing for the first time a maximum limitation on the allowance of oil and gas percentage depletion intended to terminate the well-established doctrine allowing percentage depletion on bonuses. The reasonable inference is that it did not. *See Dakota-Montana Oil Co.* v. *United States*, 288 U.S. 459 (1933).

This Court should act to prevent the judicial creation of a result in contravention of Congressional intent and inconsistent with long-standing decisions of this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

MARVIN K. COLLIE
WILLIAM M. LINDEN
JAMES A. CARTER
Counsel for Petitioners

November 5, 1982

APPENDIX A

IN THE UNITED STATES COURT OF CLAIMS

Nos. 15-80T and 16-80T

(Decided September 22, 1982)

PHILIP D. FARMAR AND MARIAN J. FARMAR, AND A. A. AND MARY S. SUGG

v.

THE UNITED STATES

William M. Linden, for plaintiffs. *James A. Carter*, attorney of record. *Marvin K. Collie* and *Vinson & Elkins*, of counsel.

Maxine C. Champion, with whom as *Assistant Attorney General John F. Murray*, for defendant. *Theodore D. Peyser* and *Donald H. Olson*, of counsel.

Before COWEN, *Senior Judge*, DAVIS and NICHOLS, *Judges*.

ON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT AND PLAINTIFFS' CROSS-MOTION FOR SUMMARY JUDGMENT

DAVIS, *Judge*, delivered the opinion of the court:

Plaintiffs, Philip D. and Marion J. Farmar, and A.A. and Mary S. Sugg, bring these consolidated refund suits to recover deficiencies assessed by the Internal Revenue Service (IRS or Service) for the taxable year 1976. Farmar and Sugg are owners of a mineral estate in lands located in Texas. They leased their ownership interests to two companies interested in oil and gas exploration. As compensation for the agreements they received lease bonuses, payable in several yearly installments; they were also to receive

royalties as oil and gas was extracted from the land. The bonuses were payable no matter if oil or gas was ever produced.[1]

In 1976, oil and gas was extracted and royalties were paid to the plaintiffs. They also received bonus payments that year. On their 1976 tax returns, they claimed a 22 percent percentage depletion deduction on both the royalty income and the bonus payments.

The IRS assessed deficiencies in federal income taxes for 1976 based on its disallowance of the percentage depletion deduction on the bonus income.[2] Taxpayers paid these deficiencies and filed claims for refunds. These were denied, leading to the present actions. Both parties have moved for summary judgment, and we agree that the basic facts are not in dispute. On those facts, we hold for the defendant.

I

For the year before us (1976), the relevant statutory tax provision is § 613A of the Internal Revenue Code, 26 U.S.C. § 613A (1976), which abolishes the percentage depletion allowance for oil and gas wells, restricting oil and gas developers to cost depletion.[3] A limited exception is provided under § 613A(c) for small independent producers and royalty owners. (It is common ground that plaintiffs fall within the category.) Subsection (c) provides that:

> (c) Exemption for independent producers and royalty owners.—
>
> (1) *In general.*—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

---

[1] If the operators abandoned the leases, they could not recover any part of the bonuses.

[2] There is no controversy over plaintiffs' right to percentage depletion deductions with respect to the royalties. Nor is there any dispute before us over cost depletion.

[3] Section 613A was enacted as part of the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501, 89 Stat. 26 (1975).

(A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

26 U.S.C. § 613A(c)(1) (1976).[4] Taxpayers covered by this subsection make their determination of gross income based on the pre-1975 rules of § 613, 26 U.S.C. § 613 (1976), and then apply the limitations and restrictions of § 613A for depletion on that income.

Plaintiffs' position is that § 613A retained the pre-existing system of depletion for independent producers and royalty owners, and merely established maximum limits on the

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[4] The next five segments of subsection (c) state:

(2) *Average daily production.*—For purposes of paragraph (1)—

(A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.

In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary).

(3) *Depletable oil quantity.*—

(A) *In general.*—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) *Phase-out table.*—For purposes of subparagraph (A)—

amount of oil and gas subject to percentage depletion. They argue that the scheme for determining the amount and timing of depletion allowances on bonus payments, developed in the Supreme Court decisions of *Burnet* v. *Harmel*, 287 U.S. 103 (1932); *Herring* v. *Commissioner*, 293 U.S. 322 (1934); and, *Douglas* v. *Commissioner*, 322 U.S. 275 (1944), is unchanged by the 1975 law. In their view, the bonus income is still subject to percentage depletion in the year it is received as long as there is oil or gas produced at some point during the life of the lease. (That was undoubtedly the pre-1975 law.) They say that bonus income can be converted to barrels per day (or cubic feet of gas) in the

In the case of production during the calendar year:	The tentative quantity in barrels is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(4) *Daily depletable natural gas quantity.*—For purposes of paragraph (1), the depletable natural gas quantity of any taxpayer for any taxable year shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have this paragraph apply. The taxpayer's depletable oil quantity for any taxable year shall be reduced by the number of barrels with respect to which an election under this paragraph applies. Such election shall be made at such time and in such manner as the Secretary shall by regulations prescribe.

(5) *Applicable percentage.*—For purposes of paragraph (1)—

In the case of production during the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

year of actual production,[5] and at that time confined to the quantity limitations prescribed in § 613A. According to the taxpayers, this conversion reconciles § 613A and § 613 so that § 613A establishes only a quantity limitation and not a production precondition to application of the percentage depletion allowance.

The government, on the other hand, insists that under the new statute, (a) depletion must be tied to actual production in the taxable year (here, 1976); (b) lease bonuses (such as those in the current cases) are not depletable at all because they are not connected with actual production; and (c) the pre-1975 law, as interpreted by the Supreme Court, was changed to allow depletion (to independent owners and royalty owners) only with respect to payments dependent on actual production in the taxable year.

II

This difference is not an easy one to resolve, and neither the text of the statute nor its legislative history gives a resounding answer. There is already a judicial dispute over the correct approach. The full Tax Court, with one dissent, has come down on the government's side. *Glass* v. *Commissioner*, 76 T.C. 949 (1981) (lease bonuses), and *Engle* v. *Commissioner*, 76 T.C. 915 (1981) (advance royalties). Since we heard oral argument in the present cases, the Seventh Circuit has reversed the Tax Court's *Engle* ruling. *Engle* v. *Commissioner*, No. 81-2463 (7th Cir. May 7, 1982). That court held that a percentage depletion allowance is permissible with respect to advance royalties, whether or not actual production occurs in the year the

[5] This conversion is accomplished, under taxpayers' theory, by allocating the bonus payment(s) over the expected productive life of the well and then dividing the price per barrel received on the extracted oil in a particular year into the bonus payment allocated to that year. This gives a barrel per day figure which is added to actual production quantities to determine if the depletable oil or gas quantities established by the statute, 26 U.S.C. § 613A(c)(3), (4) (1976), have been exceeded. Complications arise when production and sale do not occur in the same year but those problems are not present in the cases now before us.

deduction is taken. The court's theory strongly suggests, though the opinion does not hold, that the same rule applies to lease bonuses like those we have here.

In evaluating this troublesome problem for ourselves, we bear in mind some general canons for interpreting federal tax legislation. The traditional postulate is that ambiguities in statutory language should be resolved against the government. *McFeely* v. *Commissioner*, 296 U.S. 103, 111 (1935); *Gould* v. *Gould*, 245 U.S. 151, 153 (1917). However, a recognized exception, applicable to the present problem, is that provisions for deductions from income are to be strictly construed and applied in particular cases only if clearly provided for by the statutory language. *Equitable Life Assurance Society* v. *Commissioner*, 321 U.S. 560, 564-65 (1944); *White* v. *United States*, 305 U.S. 281, 292 (1938); *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U.S. 686, 689-90 (1935); *Parker Pen Co.* v. *O'Day*, 234 F.2d 607, 609 (7th Cir. 1956); *cf. A. Crawford Greene* v. *United States*, 145 Ct. Cl. 259, 268, 171 F. Supp. 459, 464, *cert. denied*, 360 U.S. 933 (1959). Deductions are a matter of legislative grace and a taxpayer has the burden of proving his entitlement to the income reduction. *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943); *Deputy* v. *DuPont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934); *cf. United States* v. *Stewart*, 311 U.S. 60, 71 (1940). More specifically for these cases, a taxpayer attempting to deduct a depletion allowance must establish that it is clearly allowed by legislation. *Parsons* v. *Smith*, 359 U.S. 215, 219 (1959); *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956); *Reinecke* v. *Spalding*, 280 U.S. 227, 232-33 (1930); *South Jersey Sand Co.* v. *Commissioner*, 267 F.2d 591, 593 (3d Cir. 1959); *Jefferson & Clearfield Coal & Iron Co.* v. *United States*, 83 Ct. Cl. 491, 494, 14 F. Supp. 918, 920, *cert. denied*, 299 U.S. 581 (1936). Ambiguities should be resolved against the taxpayer. *Consolidated Chollar Gould & Savage Min. Co.* v. *Commissioner*, 133 F.2d 440, 441 (9th Cir. 1943).

III

Though their meaning is not absolutely plain, the words of § 613A(c) suggest to us that Congress restricted percentage depletion to income derived from actual production during the taxable year, and did not merely establish a top limitation on the quantities of oil and gas subject to that kind of depletion.

It is clear, in the first place, that § 613A controls the allowance for percentage depletion (which is now limited to independent producers and royalty owners). Subsection (a) of § 613A provides (as its "general rule") that "Except as otherwise provided *in this section* [*i.e.*, § 613A], the allowance for depletion under section 611 *with respect to any oil or gas well* shall be computed *without* regard to section 613." [emphasis added] The question, then, is the method of calculation mandated by § 613A—not the method used when § 613 stood alone.

In turn, subsection (c) of § 613A (see Part I and footnote 4, *supra*), requires that the percentage oil and gas depletion allowance be computed "with respect to" "the taxpayer's average daily production" of domestic crude oil or natural gas. 26 U.S.C. § 613A(c)(1) (1976). The allowable depletable quantities are then defined in terms of production levels and the applicable depletion percentage rate and allowance is based on production during the particular taxable year. 26 U.S.C. § 613A(c)(2), (3), (4), (5) (1976).[6] The sheer fact is that, throughout § 613A(c) and (d), Congress repeatedly refers to "production" of oil and gas, and

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[6] Subsection (c)(2) deals with "the taxpayer's average daily production of domestic crude oil or natural gas *for any taxable year* * * *." [emphasis added] Production "for the [or any] taxable year" is likewise mentioned in subsection (c)(3)(ii) and subsection (c)(4). Subsection (c)(5) deals with "production during [specified] calendar year[s]." Other of the remaining provisions of subsection (c) also refer to "production" or "average daily * * * production" "for any taxable year" (subsections (c)(6), (c)(7), (c)(9), (c)(10), and (c)(12)). Subsection (d) (limiting the amount of the depletion allowance) likewise refers to "production."

frequently refers to said "production" for or during the "taxable year," in a way appearing to suggest that actual extraction was in mind.

This statutory language regularly linking depletion directly to production during a taxable year indicates to us that Congress wanted depletion to be allowable only "with respect to" income derived from, or connected with, actual extraction during the taxable year. "Production" normally means physical extraction—in the oil and gas industry as well as in common usage. Conversely, the text of § 613A is not framed so as to suggest that the depletable quantities are merely maximum limitations on the allowance of a depletion deduction, unrelated (or minimally related) to actual production.[7] The actual language embodies no such connotation.

Both the present taxpayers and the Seventh Circuit in *Engle, supra*, have stressed that this reading represents a sharp departure from the prior law, under which depletion was allowed on lease bonuses, provided that some amount of production occurred under the lease. *See Burnet* v. *Harmel, Herring* v. *Commissioner*, and *Douglas* v. *Commissioner*, all *supra*. That is true, but not controlling. If the words of later legislation fit better with such a departure than they do with retention of prior law, new language should be accepted as written (if, as we show in Part IV, *infra*, is the case here, the legislative history does not indicate otherwise). "If the section as amended is inconsistent with prior judicial interpretation of related sections, it is presumed that the legislature knew thereof, and the amendment controls." *C. Sands, Sutherland Statutory Construction*, § 22.5 at 197 (4th ed. 1972).

In the light of the specific wording of § 613A with its stress on what seems to be actual production during the taxable year, it is hard for us to believe that in these cases—involving lease bonuses which were expressly payable regardless of whether oil or gas was ever produced

[7] The statute does not provide, for example, for plaintiffs' method of converting bonus income into barrels of oil; rather, the limitation on depletable quantities is phrased in terms of barrels of oil production (or cubic feet of natural gas), and not as an income limit.

while the lease was in effect—Congress wished percentage depletion to be fully allowed each year on those bonuses (up to the stated limits) so long as a minimal amount of oil was extracted at sometime during the lease period. That may have been the case under the previous statute (*see Douglas* v. *Commissioner*, *supra*, 322 U.S. at 285 (1944)), but on its face § 613A strikes us as quite inconsistent with that rule.

Plaintiffs contend, nevertheless, that lease bonuses are sufficiently tied to production because of their economic relationship to royalties. Payment for an oil and gas lease is usually composed of a bonus and royalties. We are told that the value of the lease is determined by the expectation of a certain amount of production and that this expectation determines the price of the lease. The price is then divided (it is said) between a bonus portion and a royalty portion. The two parts of the total payment are said to be interconnected so that as one increases the other is decreased while the price remains the same, always based on the buyer's expectation of production levels.

The fundamental flaw in this analysis (assuming that plaintiffs are correct about the process of assessing the value of a lease and the division of the payment) is that the lease bonus is not tied to *actual production* but only to the parties' expectations of production. But the statutory language in § 613A infers a connection with actual, not expected, production. The lease bonus, while it may affect the predetermined royalty payment rates, is not adjusted with or sufficiently connected to actual production levels. On the contrary, it is payable here no matter what the actual production turns out to be, and even if there is no actual production. Moreover, the bonuses in these cases were per acre payments (*i.e.*, based on a land unit), not calculated per barrel produced (actual or anticipated).

Nor do we consider it a telling defect in the government's (and our) understanding of § 613A that Congress retained the old § 613 (which, standing alone, allowed percentage depletion of lease bonuses—see *supra*) in the computation of such depletion for independent operators and royalty owners. We agree with defendant that § 613A simply added a further screen for the percentage depletion

deductions of those taxpayers. They first have to show, under § 613, that they seek depletion with respect to gross income from oil property and that the allowance does not exceed the statutory percentage of their taxable income from the property. Then, the taxpayers must pass through the additional, finer screen of § 613A—showing that the depletion is based on actual production not exceeding the barrel limits imposed by the new statute. Both provisions (§ 613 and § 613A) play their separate roles, but in conjunction with each other. There is no contradiction.

This may very well have been an inartistic or awkward way in which to frame the new legislation, but courts have no right to demand legislative perfection, or even high marks in drafting—if we can ascertain the congressional purpose.[8] For us to read subsection (c) merely as imposing a top limitation, without regard to the amount of actual production, is to degrade the specific words Congress consistently used when it added § 613A to the law.

IV

A. The legislative history of § 613A is at best of minor help, but at the least we are convinced that it does not contain anything contravening the reading we (as well as the Tax Court and the government) have given to the statute.

In 1975, both Houses of Congress began consideration of a bill to reduce taxes. H. R. 2166, 94th Cong., 1st Sess. (1975). As reported, the bills did not touch on oil and gas depletion. On the floor of each House, after the bill was reported out by the respective committees, there were introduced amendments affecting the percentage depletion allowance as applied to oil and gas wells. The House version repealed the deduction altogether.[9] 121 Cong. Rec. 4638, 4651 (1975). The Senate version likewise provided for

[8] We note that this provision was basically inserted on the floor, without much time or opportunity for careful formulation in committee, or rebuilding from the ground up.

[9] A version of the amendment that retained percentage depletion for income from small quantities of oil and gas (3,000 barrels of oil or 8,000,000 cubic feet of natural gas) was narrowly defeated on the House floor on the same day. 121 Cong. Rec. 4639- 41,4645 (1975)[*sic*].

immediate repeal of percentage depletion but included an exemption for limited quantities (2,000 barrels per day and a natural gas equivalent) of oil and gas. 121 Cong. Rec. 7770-73, 7807, 7813 (1975). The conference committee adopted the Senate approach, adding an eventual complete phase-out of the allowance. H. Conf. Rep. No. 120, 94th Cong., 1st Sess. [illegible] *printed in* [1975] U.S. Code Cong. & Ad. News 132-34. This language was enacted as § 613A.

There was no floor discussion (nor statement in the conference report) directly on the problem before us, one way or the other. We stress, however, that nothing said in the debate or report was inconsistent with the requirement that depletion cannot be had on lease bonus payments. Certainly, reading § 613A(c) as confining percentage depletion to income received from actual production does not conflict with what appears to have been one of the purposes of the oil-and-gas depletion portions of the 1975 tax act—the encouragement of actual and immediate production of those commodities. *See* Comment, *Tax Law and the Energy Crisis*, 64 Cal. Law Rev. 1040, 1061-63 (1976).

B. The only reference to the precise issue before us occurred in the immediately preceding Congress. In 1974, a bill was introduced in the House to eliminate the depletion allowance on income earned from oil and gas wells. H.R. 17488, 93d Cong., 2d Sess. (1974). It included an exemption for small interest holders and allowed the deduction "with respect to so much of his average daily production of domestic crude oil as does not exceed 3,000 barrels."[10]

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[10] H.R. 17488, § 112(a):

(b) *3,000 Barrel-A-Day Exemption.*—

(1) *In general.*—If the taxpayer elects the application of this subsection for the taxable year, then with respect to so much of his average daily production of domestic crude oil as does not exceed 3,000 barrels, the percentage referred to in section 613(a) shall be 15 percent in the case of gross income from the property before January 1, 1979.

(2) *Average daily production.*—For purposes of paragraph (1), the taxpayer's average daily production of domestic crude oil shall be determined by dividing his aggregate production of domestic crude oil during the taxable year by the number of days in such taxable year.

Concerning this tie to actual production, the House Committee on Ways and Means (reporting the bill) explained:

> The small production exemption applies to gross income attributable to a proportion of *actual* production ... Thus, the 15 percent rate applies only to gross income attributable to oil which is sold or removed from the premises and not to other types of depletable income. *For example, a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions.* [emphasis added]

H. Rep. No. 1502, 93d Cong., 2d Sess. 46 (1974). The bill was introduced late in the congressional session and was never acted upon by the full House or introduced in the Senate.

In *Engle*, the Seventh Circuit gave no credit whatever to this committee statement because it related to an earlier bill in an earlier Congress, and there is no indication that the later Congress (particularly the Senate) knew of or considered those views. We do not lean heavily on the earlier report, but we do not disregard it entirely (as the Seventh Circuit did). The prior bill was very similar to § 613A (though different in limits and percentages). There are, too, references in both the House and Senate debates in 1975 to the small producer exemption in the 1974 bill.[11] 121 Cong. Rec. 4646, 6903, 7777 (1975). These observations are entitled to some consideration (as indicating some knowledge of the earlier bill) because this section of the statute was initially adopted as a floor amendment (after completion of the House and Senate committee reports) and there was extensive debate on the oil depletion allowance part of that bill. *See* 121 Cong. Rec. 4622-52, 6903-05, 7218-29, 7238-48, 7263-7308, 7772-7813, 8128-29, 8860, (1975); *Depletion Allowance, Hearing Before the Subcomm. on Energy of the Senate Comm. on Finance*, 94th Cong., 1st Sess. (1975).

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[11] These comments do not refer to the production-link requirement but they do indicate an awareness, by at least some of the members involved in the floor discussion, of the 1974 bill and the exemption for small producers it contained.

Because the House bill in the 1975 Congress originally included total repeal of the oil depletion allowance, plaintiffs contend that the House could not have intended to follow the 1974 House Committee on Ways and Means bill; and therefore the prior statement should be wholly bypassed. But the 1975 House version entirely repealing the allowance was not ultimately adopted and it cannot represent the intent of the House with respect to § 613A. The conference committee substitute, which contained exemption language very similar to that in the prior H.R. 17488, was eventually adopted by both Houses and is a better indication of congressional purpose. *See Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 246 n.4, 264 n.31, 32, and accompanying text (1945). Moreover, even during the initial House discussions, an exemption for independent producers and royalty owners, based on production levels, was considered and narrowly voted down. *See* footnote 9, *supra*. The idea of a special exemption for small entities, expressly involving production, was very much in the air in the 94th Congress, and it is not unlikely that the prior report was known to several, if not many, of the members who considered § 613A.

On the whole we cannot completely disregard the 1974 committee report as having no bearing on the 94th Congress' consideration and passing of § 613A. It is the only significant reference to the issue before us, and clearly supports the government's position. In the absence of any real contradictory history, that report should have some (though, of course, not compelling) weight.

C. We do not consider this item of history overborne by the failure of Congress to address directly the Supreme Court decisions which would be superseded by our reading of § 613A. The 1974 Committee report did not do so and it is expecting too much to look for such discussion in a later floor debate devoted entirely to other aspects of oil depletion. The important point is whether the terms of the new statute are inconsistent with those earlier decisions. If they appear to be so—and we think that they do—there is no requirement that Congress say so explicitly. *See* Part III, *supra*.

V

The Service has consistently interpreted § 613A contrary to plaintiffs' view, and while it is not at all binding we should not overturn that position unless we find if contrary to the statute—as we have not done. In its revenue rulings, the IRS has held that income attributable to a lease bonus is not subject to the percentage depletion allowance. Rev. Rul. 81-44; Rev. Rul. 81-266.[12]

Plaintiffs say that Rev. Rul. 81-266, *supra*, establishes that a lease bonus is subject to a percentage depletion allowance—that, by holding that the lessee must subtract the bonus from its gross income calculation thereby excluding the lessee from taking the deduction, the Service must be endorsing depletion of that income by the lessor. Under the bonus exhaustion rule, taxpayers argue, the deduction may be taken by either the lessor or the lessee, but not both, and removing it from the lessee simply shifts the depletion allowance to the lessor (or vice versa). This is,

[12] Revenue rulings are not binding on this court. *Pacific Far East Line, Inc.* v. *United States*, 211 Ct. Cl. 71, 93, 544 F.2d 478, 490 (1976); *State Bank of Albany* v. *United States*, 209 Ct. Cl. 13, 19, 530 F.2d 1379, 1382 (1976); *Stubbs, Overbeck & Associates, Inc.* v. *United States*, 445 F.2d 1142, 1146-47 (5th Cir. 1971) (J. Skelton). They are not accorded a presumption of correctness but must be analyzed for consistency with the statute. *Estate of Sanford* v. *Connecticut*, 308 U.S. 39, 52-54 (1939); *United States* v. *Missouri Pacific Railroad Co.*, 278 U.S. 269, 280 (1929); *United States* v. *Eddy Bros.*, 291 F.2d 529, 531 (8th Cir. 1961); *Investment Annuity, Inc.* v. *Blumenthal*, 442 F. Supp. 681, 687-94 (D.C. Cir. 1977), *rev'd on other grounds*, 609 F.2d 1 (D.C. Cir. 1979), *cert. denied*, 446 U.S. 981 (1980). Nevertheless, they are entitled to some consideration and carry some weight, especially when the statutory language is considered ambiguous. *Gino* v. *Commissioner*, 538 F.2d 833, 835 (9th Cir.), *cert. denied*, 429 U.S. 979 (1976); *Eddy Bros.*, 291 F.2d at 531; *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201, 228-29 (N.D. Iowa 1949). This stance is consistent with the general deference accorded an IRS interpretation, as well as the Commissioner's authority to choose between reasonable interpretations. *National Muffler Dealers Assn.* v. *United States*, 440 U.S. 472, 477, 488 (1979); *United States* v. *Correll*, 389 U.S. 299, 307 (1967); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336, 340 (2d Cir. 1980).

however, an incorrect reading of the revenue ruling. Rev. Rul. 81-266 expressly upholds the conclusion in Rev. Rul. 81-44 excluding bonus income from percentage depletion. It also points out that under § 613A the lessee cannot deplete bonus income but must subtract it from its gross income under § 613. Neither lessor nor lessee can obtain percentage depletion.

In addition to the revenue rulings, the administrative position is bolstered by the regulation proposed by the Service to implement § 613A(c) which emphatically excludes percentage depletion on lease bonus payments.[13] Proposed regulations are not binding but have some authority as an indication of administrative practice. *See Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201, 229 (N.D. Iowa 1949).

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[13] Proposed Treasury Regulation 1.613A:

§ 1.613A-3 *Exemption for independent producers and royalty owners.*

* * * * *

(4) The provisions of this paragraph may be illustrated by the following examples:

* * * * *

Example (5). In 1975, E leased an oil property to F, receiving a lease bonus. With respect to the lease bonus, E is entitled to take cost depletion but not percentage depletion.

* * * * *

§ 1.613A-7 *Definitions.*

* * * * *

(f) *Average daily production.* (1) The term "average daily production" means the taxpayer's average production of domestic crude oil or natural gas, as the case may be, which is produced after December 31, 1974, and to which gross income from the property is attributable during the taxable year divided by the number of days in such year. * * * Notwithstanding the provisions of § 1.612-3, of this chapter, in computing the average daily production for a taxable year only oil or gas which has been produced by the close of such taxable year shall be taken into account. For example, advanced royalties (to the extent that actual production during the taxable year is insufficient to earn such royalties) and lease bonuses, while taken into account for purposes of sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A(c). * * *

VI

Primarily on the basis of the language of § 613A, but with minor help from the legislative history and the consistent administrative interpretation, we conclude that plaintiffs have not met the burden of showing that they are entitled to a deduction under § 613A—they have not convinced us that the statute omits the requirement of a direct link to actual production for oil and gas income to be subject to the percentage depletion allowance. Our overall views do vary from those expressed by the *Engle* case, but the ultimate holdings of the two sets of cases may not necessarily be inconsistent. We are concerned here with lease bonuses, not tied at all to actual production, and we confine our decision to that subject. The Seventh Circuit dealt with advance royalties which may possibly be considered somewhat different, and more closely related to actual production.[14]

For these reasons, we grant defendant's motion for summary judgment and deny plaintiffs' motion. The petitions are dismissed.

[14] *Engle* focused on the question whether the depletion deduction and actual production must be in the same year.

APPENDIX B

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 81-2463

FRED L. AND MARY A. ENGLE,
PETITIONERS-APPELLANTS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Appeal from the United States Tax Court.

ARGUED FEBRUARY 16, 1982–DECIDED MAY 7, 1982

Before PELL, *Circuit Judge*, FAIRCHILD, *Senior Circuit Judge*, and BAUER, *Circuit Judge*.

PELL, *Circuit Judge*. Taxpayers Fred and Mary Engle appeal from a decision of the United States Tax Court upholding a determination by the Commissioner that they were not entitled to a percentage depletion allowance on two oil and gas leases for the year 1975. The Engles had received advance royalties as a result of their assigning the leases during the taxable year. No physical extraction of oil or gas from the depletable properties had occurred during 1975. The Tax Court held that 26 U.S.C. § 613A(c) (1976)[1]

[1] Unless otherwise indicated, all statutory references in this opinion are to the Internal Revenue Act of 1954, as amended, codified at Title 26 of the United States Code.

permits the percentage depletion deduction only if there is some physical extraction of oil or gas during the taxable year.

The sole issue on appeal is whether the Tax Court correctly interpreted section 613A(c) to preclude a taxpayer otherwise entitled to the percentage depletion allowance from claiming the deduction if there was no physical extraction of oil or gas from the depletable properties during the year for which the percentage depletion allowance is claimed.

I. FACTS

The facts are undisputed. Fred and Mary Engle are husband and wife. They filed a joint federal income tax return for 1975. During that year, Fred Engle acquired two oil and gas leases covering a total of 240 acres of land in Wyoming. Both leases were assigned by Engle to different parties in October, 1975. Engle received advance royalties of $7,600 from the two assignments. This $7,600 was the only taxable income received from the properties during 1975. No discovery or exploratory work was done on the properties covered by the leases during the taxable year; no gas or oil was extracted from the properties that year.

The Engles claimed a 22% depletion deduction, pursuant to section 613A. The Commissioner determined that the Engles were not entitled to the deduction because there was no "average daily production." § 613A(c), of domestic crude oil or natural gas and no average daily secondary or tertiary production of domestic crude oil or natural gas during 1975. The Commissioner assessed a deficiency of $4,957.55.[2] A majority of the Tax Court upheld the Commissioner's interpretation in a majority and concurring opinion that together span forty-six pages.[3] Judge Fay strongly dissented from the conclusion that the "average

[2] The deficiency also reflects other items of adjustment to which the appellants have not taken exception.

[3] The Tax Court held that the appellants were entitled to a cost depletion allowance, *see* § 612. There is, however, no indication that the taxpayers ever claimed cost depletion.

daily production" language of section 613A(c) makes actual physical extraction of gas or oil a prerequisite to the percentage depletion deduction.

II. DISCUSSION

We note at the outset that the pertinent language of section 613A(c) has not previously been interpreted by a court of appeals. We must consider the statutory language, pertinent legislative history, and the judicial interpretation of the percentage depletion allowance as it existed prior to enactment of section 613A[4] in construing the challenged provision. We begin by setting forth the stautory scheme for percentage depletion allowances as it existed prior to enactment of the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975) (1975 Act).

A. Sections 611 and 613 of Title 26.

Prior to promulgation of the 1975 Act, percentage depletion allowances were governed solely by sections 611 and 613. Section 611(a) states, in relevant part, that "there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion . . ." § 611(a). Section 613, entitled "Percentage Depletion," states in part: "In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the *gross income from the property. . . .*" *§ 613(a) (emphasis added).*

[4] The Government appears to contend that judicial interpretations of section 613, the statutory section governing percentage depletion prior to enactment of section 613A, are irrelevant to this appeal because of the impact of section 613A. We disagree. As discussed in more detail *infra*, section 613A(c)(1) requires computation in accordance with section 613. Further, we think that the prior statutory scheme is relevant to the extent that the current statutory language fails to evidence a clear intent on the part of Congress to effect a different result under the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975). *Cf. Helvering v. Morgan's, Inc.*, 293 U.S. 121, 126-27 (1934) (construing the phrase "taxable year" by reference, in part, to interpretation of the term under previous revenue laws).

The Supreme Court made clear that if the depletable properties resulted in gross income to the taxpayer, the percentage depletion allowance was applicable whether or not any physical extraction occurred during the taxable year. *E.g., Herring v. Commissioner,* 293 U.S. 322 (1934). The ruling in *Herring* was in response to the Commissioner's conclusion that section 214(a)(9) of the Revenue Act of 1926 contemplated actual production as a prerequisite to the percentage depletion allowance. The Commissioner had reasoned that no oil or gas well existed absent production and the statutory language permitted the "reasonable allowance for depletion" only "[i]n the case of mines, oil and gas wells . . . ." It is clear, therefore, that the Engles would have been entitled to the percentage depletion allowance on the basis of their advance royalties had this case arisen prior to promulgation of the 1975 Act.

It was also established, prior to the 1975 Act, that if *no* production of oil or gas occurred prior to cancellation of the lease, the taxpayer was required to restore the previously deducted depletion to income. *Douglas v. Commissioner,* 322 U.S. 275, 285 (1944); 26 C.F.R. §§ 1.612.3(a)(2) and (b)(2) (1981). As the Tax Court noted in the instant case, this rule constituted at least an implicit requirement of actual production of oil or gas at some point in time.

B. The 1975 Act.

The 1975 Act essentially eliminated the percentage depletion allowance in the case of oil and gas wells except as to certain domestic gas wells and independent producers and royalty owners. *See* §§ 613A(a), (b), and (c). The latter exception is the one relevant to this appeal. That subsection provides in part:

> (c) Exemption for Independent Producers and Royalty Owners—
>
> (1) In general.—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

> (A) So much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and
>
> (B) so much of the taxpayer's average daily production of natural gas as does not exceed the taxpayer's depletable natural gas quantity;
>
> and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

§ 613A(c)(1).

A majority of the Tax Court reasoned that physical extraction during the taxable year is a prerequisite if the percentage depletion allowance is to be determined "with respect to . . . average daily production." The Tax Court also relied on language in two subsections which specify the tentative number of barrels in a taxpayer's "depletable oil quantity" and the applicable percentage to be used in computing the percentage depletion deduction. Each of these tables refers to "production during the calendar year." §§ 613A(c)(3) and (5). Because of this language, the Tax Court concluded that "the express language of section 613A(c) limiting the percentage depletion deduction to stated quantities of production is so clear that it permits no other reasonable interpretation" than that urged by the Commissioner.

In his brief before this court, the Commissioner argues that the term "production" means marketable oil or gas and, therefore, Congress clearly contemplated physical extraction in using that term. The Commissioner reasons that only if this extraction prerequisite is satisfied, should one refer to section 613(a). He concludes, as did the Tax Court, that the reference in section 613A(c) to "comput[ation] in accordance with section 613" was intended by Congress to incorporate into section 613A the numerous Regulations, Revenue Rulings and court opinions that had interpreted how the "gross income from the property" and the "taxable income from the property" were to be computed pursuant to section 613.

The appellants maintain, by contrast, that one must first look to section 613 and determine whether there is gross income from the depletable property. If there is, the percentage depletion allowance is available to the taxpayer regardless of whether physical extraction occurred during the year for which the deduction is claimed. The reference to "average daily production" in section 613A constitutes a *limitation* on the amount of deduction that a taxpayer may claim rather than a prerequisite.[5]

We will analyze this statutory language in Section II(D), *infra*, of this opinion. We do note at this time that, contrary to the conclusion stated by the Tax Court, we find the statutory language to be ambiguous. We therefore turn to the legislative history of the statute.

C. Legislative History.

An understanding of legislation before Congress in both 1974 and 1975 is necessary to determine the relevance of portions of the legislative history relied on by the parties.

During 1974, the House Committee on Ways and Means considered H.R. 17488. 93d Cong., 2d Sess. (1974). That bill generally repealed percentage depletion. It allowed

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[5] For instance, assume that during 1975 a depletable property produced 800,000 barrels of oil, none of which represented secondary or tertiary production. Section 613A(c)(3)(B) provides that the taxpayer would have a depletable oil quantity of 2,000 barrels. In order to determine the allowable percentage depletion, one would first establish the average daily production by dividing 800,000 by 365 days, § 613A(c)(2)(A), which results in approximately 2,190 barrels. This exceeds the depletable oil quantity of 2,000 barrels and, therefore, the taxpayer could claim the percentage depletion allowance under section 613A(c)(1) with respect to only a portion of his actual production.

As the Tax Court noted, the "average daily production" language cannot state an absolute ceiling on quantities of production entitled to percentage depletion because other subsections prescribe specific rules for treatment of production in excess of the tentative barrel limitations stated in section 613A(c)(3)(B). *See* § 613A(c)(7). This does not, in our view, preclude the appellants' argument that the references to "average daily production" are intended to distinguish the production eligible for treatment under section 613A(c)(1) from that which is subject to the "special rules" of section 613A(c)(7).

three exemptions from the repeal including one for small producers.[6] The bill was reported out of Committee but no further action was taken on it. It was never reviewed by the Senate, the Finance Committee of the Senate, or the Joint Committee.

In 1975, H.R. 2166, 94th Cong., 1st Sess. (1975), was ordered reported to the House. There was *no* provision in the committee version of that bill eliminating percentage depletion on income from oil and gas wells.[7] A House floor amendment introduced repeal of percentage depletion into H.R. 2166. 121 Cong. Rec. 4651-4652 (1975). That amendment contained none of the exceptions that had been part of H.R. 17488. H.R. 2166 then went to the Senate where an exemption for independent royalty owners and producers was added. The Senate amendment differed from the exemption that had been contained in H.R. 17488 in several respects. For example, the Senate amendment allowed percentage depletion at a rate of 22% and with respect to an average daily production of 2,000 barrels whereas H.R. 17488 had provided for percentage depletion at the rate of 15% with respect to the first 3,000 barrels of production per day. The Conference Committee considered the Senate amendment, *see* H.R. Conf. Rep. No. 94-120, 94th Cong., 1st Sess. 5768, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 132-34 (Conference Committee Report), and modified it in some respects not relevant to the issue before this court. This amendment was later codified as Section 613A(c).

The only reports that discuss the retention of percentage depletion for independent producers and royalty owners are *H.R. 17488: Energy Tax and Individual Relief Act of 1974*, H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 46 (1974) (H.R. 17488 Report), and the Conference Committee Report cited above. As at least one commentator has noted, there is little record of meaningful Congressional debate on

[6] The exemptions for production from stripper wells and the North Slope of Alaska are irrelevant to the case at bar.

[7] The related report of the House Committee on Ways and Means, H.R. Rep. No. 94-19, 94th Cong., 1st Sess. (1975), makes no reference to percentage depletion.

the provisions that were codified as section 613A, largely because of the rush to pass the 1975 Act. Bavenic, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 Oil & Gas Tax Q. 204, 204 (1975).

The Government has relied heavily in its brief on the H.R. 17488 Report. Initially, we must assess whether that reliance is warranted. The report states in part: "[A] lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be in any of the exemptions." H.R. 17488 Report at 46. Because lease bonuses and advance royalties have been treated similarly for tax purposes, it is apparent that the above-quoted language would be relevant to this case had H.R. 17488 been enacted into law.

The commissioner argues that the H.R. 17488 Report is relevant to this case on the authority of *Helvering v. Morgan's, Inc.*, 293 U.S. 121 (1934), and *Helvering v. New York Trust Co.*, 292 U.S. 455 (1934). The *Morgan's* Court was construing the term "taxable year" as used in section 200(a) of the Revenue Act of 1926. That Court stated "the true meaning of a single section of a statute in a setting as complex as that of the revenue acts cannot be ascertained ... if the mind be isolated from the history of the income tax legislation of which it is an integral part." 293 U.S. at 126 (citation omitted). The *Morgan's* Court was not, however, discussing whether legislative history of a bill *never enacted* was relevant to its interpretation of section 200(a); rather, the Court referred to the rule established pursuant to earlier *enacted* revenue laws that "taxable year" related to a twelve-month accounting period of the taxpayer. Similarly, the references in *New York Trust Co.* to legislative intent cannot be read as mandating consideration of the legislative history of a bill that was never enacted.

The Commissioner has failed to provide persuasive precedent for his contention that the legislative history of H.R. 17488 is relevant to this appeal. We note that the Tax Court did not rely on the H.R. 17488 Report. We think that the legislative developments in 1974 and 1975 undercut the Commissioner's reliance on statements pertinent to H.R.

17488. In the Committee version of H.R. 2166, the House *retained* the percentage depletion rules as they then existed. This is the opposite position from that taken by the same Committee in H.R. 17488. It is extremely difficult, as a matter of common sense, to conclude from this pattern that the intent of the House in 1974 remained unchanged in 1975. Second, the Senate never considered H.R. 17488. Although the Senate was undoubtedly aware that H.R. 17488 had contained an exemption for independent producers and royalty owners, the Senate version of H.R. 2166 did not contain an exemption identical to that contained in H.R. 17488. On the basis of these facts, we cannot conclude that the intention of the House Ways and Means Committee in 1974 to abolish percentage depletion for advance royalties was necessarily shared by the legislators who eventually enacted H.R. 2166. We find, therefore, that remarks contained in the H.R. 17488 Report are of little, if any, relevance to the issue before us.

Turning to the scant legislative history that is relevant to the enacted legislation, the Government relies on the following passage:

> The conference substitute follows the Senate amendment in providing a small producer exemption from the repeal of percentage depletion for oil and gas. Initially the exemption ("depletable oil quantity") is 2,000 barrels of average daily production (or 12,000,000 cubic feet of natural gas).

Conference Committee Report at 68, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 133. The Government also quotes the statement by Representative Vanik that the Committee version of H.R. 2166 provided "a scheduled reduction in barrels of daily oil production eligible for 22 percent depletion which goes down to 1,000 barrels." 121 Cong. Rec. 8924 (1975). Finally, the Commissioner refers to statements made during Congressional debates which indicate that Congress was primarily concerned with encouraging further exploration of domestic oil and gas resources

at the time it enacted the 1975 Act.[8] This concern, in the appellee's view, compels the conclusion that Congress intended the percentage depletion deduction to be available only when physical extraction of gas or oil occurred.

The taxpayers also rely on several portions of the Conference Committee Report. First, they quote: "[T]he Senate amendment retains percentage depletion at 22 percent on a permanent basis for the small independent producer to the extent that his average daily production of oil does not exceed 2,000 barrels a day, or his average daily production of natural gas does not exceed 12,000,000 cubic feet." Conference Committee Report at 67, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 132. They reason that the word "retains" evidences a Congressional intent to leave undisturbed the body of prior law that premised percentage depletion on gross income regardless of physical extraction. Second, the appellants cite several portions of the Conference Committee Report which refer to the exemption as the "small producer exemption." *Id.* at 67-68, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 133-34. In the taxpayers' view, this language supports their argument

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[8] *E.g.*, 121 Cong. Rec. 4606 (1975) (remarks of Rep. Rhodes) ("I think we should all recall that one of the reasons for this bill being brought here with some haste is the fact that we have a shortage of domestic petroleum").

The Government also relies on language utilized by the Senate Committee on Finance when it considered certain technical changes in section 613A after enactment of the legislation:

> Under the other exception (the "small producer exemption"), percentage depletion is allowed for a limited amount of production from wells located within the United States. The amount of production eligible for percentage depletion is an average of 2,000 barrels per day (or its equivalent in cubic feet of gas) for 1975 and phases down to an average of 1,000 barrels per day (or its equivalent in cubic feet of gas) for 1980 and thereafter.

S. Rep. No. 94-938, 94th Cong., 2d Sess. 424 (1976). The Government maintains that this report is entitled to consideration as a "secondarily authoritative expression of expert opinion," citing *Bobsee Corp. v. United States*, 411 F.2d 231, 237 n.18 (5th Cir. 1975). We need not resolve what weight, if any, should be attributed to this quotation because we find it no more explicit as to Congressional intent than the language of the statute or the Conference Committee Report.

that the "average daily production" language of section 613A(c) states only a *limitation* on the quantity of production eligible for the percentage depletion allowance.

D. Analysis.

Looking first at the statutory language itself, we find the arguments presented by both parties to this controversy to be reasonable interpretations. As the Government asserts, section 613A(c) makes repeated reference to the term "average daily production." Further, the charts contained in subsections 613A(c)(3) and (5) suggest that Congress was focusing on actual production during the taxable year for which the depletion allowance was claimed.

On the other hand, it is equally clear that the overriding effect of section 613A is to limit the percentage depletion allowance in the case of oil and gas wells. Section 613A(c) makes an exception for "small producers." To that end, some specification of the quantity of oil or gas for small producer eligibility was necessary. Congress might well have chosen to articulate this limitation by reference to "average daily production." It is also true, as the appellants urge, that interpreting physical extraction to be a prerequisite could lead to absurd results. Pursuant to such an interpretation the Engles might have claimed the depletion allowance had one barrel of oil been produced from the leased properties during 1975. Further, the section 613 basis of calculation by reference to gross income is explicitly incorporated into section 613A by the provisions of both sections 613(d) and 613A(c). Nothing in the statutory language specifically supports the Tax Court's conclusion that Congress intended to incorporate only the methods of calculating "gross income from the property" and "taxable income from the property" while abandoning gross income as the basis of the deduction.

The legislative history is of little help in resolving the statutory ambiguity. A Congressional interest in furthering exploration of domestic sources of gas and oil is not inconsistent with applicability of the percentage depletion allowance to advance royalties. The established rule that deducted depletion must be restored to income if there is no

production of oil or gas prior to cancellation of the lease, *Douglas v. Commissioner*, 322 U.S. 275, 285 (1944), in itself provides an incentive to production.

The portions of the Conference Committee Report cited by the Government do little more than repeat, without clarifying, the statutory references to average daily production. We find nothing in the cited language that elucidates whether "average daily production" was intended as a prerequisite or merely as a limitation on the amount of production subject, without invocation of the "special rules" of section 613A(c)(7), to the percentage depletion allowance.

Similarly, we cannot find dispositive the Conference Committee's use of the word "retains." In light of the general repeal of the allowance in the case of oil and gas wells effected by section 613A, the section 613A(c) provision clearly does "retain" percentage depletion for small producers whether or not physical extraction is made a prerequisite.

Section 613A(c) not only fails to address clearly the situation at bar; its impact is similarly ambiguous whenever physical extraction and gross income resulting from that production occur in different taxable years. The lengthy dissent to the Tax Court opinion, written by Judge Fay, spends considerable time pointing out these problems. Without setting forth in detail his analysis, we do note one of the problems left unsolved by the statute. In the case of a taxpayer who had an "average daily production," as the Commissioner construes that term, of 100 barrels a day in 1980 but received no gross income from that production until 1981, the "prerequisite" of actual production in 1980 would be satisfied but calculation of the percentage depletion allowance for that year, based on gross income, appears impossible because the depletable properties produced no income during the taxable year.

Section 613A(c) provides no method for "converting" the barrels to income so as to enable the taxpayer to claim the deduction in 1980. If the allowance with respect to the 100 barrels average daily production is instead allowed in 1981, the result is at odds with the statutory language defining "average daily production" in terms of the taxable year,

§ 613A(c)(2), because the "production" occurred in 1980. Similarly, it becomes unclear whether the applicable depletable oil quantity, *see* § 613A(c)(3), should be that stated for 1980 or 1981 and what "applicable percentage," see § 613A(c)(5), should apply. Regulations proposed by the Treasury Department would allow the deduction in 1981 but no percentage depletion allowance in 1980 on these facts. Proposed Income Tax Regulations § 1.613A-3(a)(4)(7), 42 Fed. Reg. 24281 (May 3, 1977).[9] The obvious difficulty with this proposed regulation is that it is inconsistent with the language of section 613A(c) if "production" means literal physical extraction during the taxable year for which the allowance is claimed.[10]

[9] Our attention has been called to no proposed regulation specifically addressing the applicable percentage depletion quantity and the applicable percentage in such a case. In his concurring opinion below, Judge Goffe seems to assume that the 1981 quantity and percentage would apply under the proposed regulations, a result with which he disagrees.

[10] The result urged by the Commissioner in this case, a denial of the percentage depletion deduction with respect to advance royalties, is specifically embodied in another of the proposed regulations. Section 1.613A-7(f)(1) states:

> For example, advanced royalties (to the extent that actual production during the taxable year is insufficient to earn such royalties) and lease bonuses, while taken into account for purposes of sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A(c).

Under section 1.613A-7(f)(1), the allowance is *denied* when income is received in a year prior to extraction. Under section 1.613A-3(a)(4)(7), discussed *supra*, the deduction is *allowed* when the situation is reversed and extraction occurs in a taxable year prior to the year in which income results from the production. This inconsistency in the treatment of "production" and "income" arising in different taxable years is not supported by any logic. The purported goal of increasing exploration of domestic sources of oil and gas is an insufficient explanation given that prior law included an incentive to actual production, the "recovery" of a deduction calculated on advance royalties that was not matched with production before the conclusion of the lease term.

In summary, we find little guidance in either the statutory language or the relevant legislative history as to whether Congress intended to eliminate the percentage depletion allowance for advance royalties.

CONCLUSION

In his concurring opinion, Judge Goffe states: "The majority opinion has, in my view, taken a mangled statute that is unattended by any germane or informative legislative history and has interpreted it by a direct and simple construction of one of the least ambiguous words in the statute: production." Insofar as the Tax Court concludes that "production" requires physical extraction, the construction is indeed straightforward. To conclude that production is a *prerequisite*, however, is a far less "simple" and far less justified interpretation.

The efforts of the Tax Court, as demonstrated by the length of its opinions, to settle on a reading of the statute that will permit consistent application were unsparing. As the hypothetical situation above illustrates, however, the result reached by the Tax Court does not resolve all the statutory ambiguities that pertain to receipt of income from the depletable properties in a different year from the year in which physical extraction occurs.

The reading urged by the taxpayers does not deny that physical extraction is inherent in the term "production." It differs from the Tax Court's interpretation in that it characterizes "average daily production" as a limitation rather than as a prerequisite. Admittedly, this reading of the statute does not clarify all the ambiguities inherent in section 613A(c). For instance, it does not resolve in what year the percentage depletion allowance should be taken if physical extraction occurs in a year *prior* to the receipt of related gross income.

We cannot reject the taxpayer's reading of the statute merely because it leaves unanswered questions. The interpretation of the Tax Court suffers the same defect. To the extent that the Treasury Department and the Tax Court *have* resolved these questions, they have done so by

starting with the conclusion that production is a prerequisite and construing other ambiguous portions of the statute so as not to conflict with that interpretation.

The reading of the statute endorsed by the Tax Court effects a drastic change from the prior law regarding the availability of percentage depletion allowances for advance royalties. There is no explicit statement in any of the pertinent legislative history that Congress intended to achieve such a result. By contrast, the interpretation of the statute urged by the taxpayers results in far less marked a change: section 613A(c) changes for formula for computing percentage depletion for those whose production exceeds the limitation that is stated in terms of "average daily production." This interpretation does not deny the deduction to an entire class of royalty owners.

Absent any clear expression of Congressional intent, in either the statutory language or the attendant legislative history, to deny the percentage depletion allowance to taxpayers in the Engles' situation, we conclude that "production" cannot be read as a prerequisite to the deduction. The judgment of the Tax Court therefore is

REVERSED.

APPENDIX C

76 T.C. 915

UNITED STATES TAX COURT

FRED L. AND MARY A. ENGLE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 6219-79.
Filed June 8, 1981.

Petitioners made assignments in 1975 of two oil and gas leases held by them, retaining, however, overriding royalties of 4 percent from one lease and 5 percent from the other. As part of the consideration for the assignments, they received advance royalties totaling $7,600. There was no production of oil or gas from either of the leases during 1975.

Held: Under sec. 613A(c), I.R.C. 1954, petitioners are not entitled to deduct percentage depletion with respect to the advance royalties in 1975.

Thomas J. Donnelly, for the petitioners.

Robert M. Fowler, for the respondent.

OPINION

FEATHERSTON, *Judge:* Respondent determined a deficiency in the amount of $4,957.65 in petitioners' Federal income tax for 1975. Petitioners failed to take exception to certain items of adjustment; therefore, the only issue for decision is whether a percentage depletion deduction is allowable under section 613A[1] with respect to $7,600 that petitioners received in 1975, as advance royalties, under the terms of their assignment of two oil and gas leases.

[1] All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

All of the facts have been stipulated.

At the time the petition was filed, petitioners, who are husband and wife, were legal residents of Hartland, Wisconsin. They filed their joint Federal income tax return for 1975 with the Internal Revenue Service Center, Kansas City, Missouri.

Effective July 1, 1975, petitioner Fred L. Engle (Fred) procured an oil and gas lease covering 80 acres of land in Campbell County, Wyoming. On October 6, 1975, he assigned the lease to Getty Oil Company, retaining, however, a 5-percent overriding royalty.[2] As part of the consideration for the assignment, he received an advance royalty in the amount of $6,000.

Fred was also the lessee under an oil and gas lease, effective beginning September 2, 1975, covering 160 acres of land in Carbon County, Wyoming. On October 22, 1975, petitioners assigned this lease to Marshall & Winston, Inc.,[3]

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[2] The term "royalty," as used in the area of natural resources taxation, refers to a fractional interest in the "production" (i.e., extraction) of oil and gas or other minerals that is created by the owner (in fee) of the minerals. F. Burke and R. Bowhay, Income Taxation of Natural Resources, sec. 2.03 (1980); 1 L. Fiske, Federal Taxation of Oil and Gas Transactions, sec. 2.08 (1980 Rev.).

As stated in Income Taxation of Natural Resources, *supra* at sec. 2.05:

> An overriding royalty is similar to a royalty in that, for Federal tax purposes, each is a right to minerals in place that entitles its owner to a specified fraction of production, in kind or in value, and neither is burdened with the costs of development or operation. They differ in that an overriding royalty is created from the operating interest, and its term is co-extensive with that of the operating interest from which it was created.
>
> The overriding royalty may be carved out or retained. It is said to be carved out if the owner of the working interest assigns a right to a fractional share of production free and clear of development and operating expense. It is retained if the lessee assigns the working interest and retains a fractional share of production free of development and operating costs.

For convenience, we shall herein use the term royalty in a more general sense in referring to the advances that petitioners received on overriding royalties.

[3] Although only Fred had signed the lease as lessee, both petitioners executed the assignment to Marshall & Winston, Inc.

retaining a 4-percent overriding royalty. As part of the consideration for the assignment, they received an advance royalty in the amount of $1,600.

The amounts received as consideration for the assignments of the leases constituted the only taxable income from the described properties in 1975. There were no related expenses. Prior to the end of 1975, no discovery or exploratory work had been done on the properties covered by the leases, and no oil or gas had been produced from the properties. During 1975, petitioners had no average daily production of domestic crude oil or natural gas and no average daily secondary or tertiary production of domestic crude oil or natural gas, within the meaning of section 613A(c), quoted in footnote 8, *infra*, which provides a limited deduction for percentage depletion in the case of oil and gas wells.

Section 611(a) provides in part that, in the case of mineral deposits (including oil and gas wells), "there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion." In theory, this deduction is allowed in order to permit the holder of an "economic interest" in minerals in place to recover his capital investment in those minerals tax-free.[4] See sec. 1.611-1(b)(1), Income Tax Regs.; *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 602-603 (1946); *Palmer* v. *Bender*, 287 U.S. 551, 557-558 (1933). For purposes of computing the deduction, Congress has provided two different methods, cost depletion[5] and percentage depletion,[6] and, where a taxpayer is

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[4] In practice, a taxpayer may be able to recover his investment several times over due to the allowance of percentage depletion, under secs. 613 and 613A, which will be discussed *infra*.

[5] SEC. 612. BASIS FOR COST DEPLETION.

Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain upon the sale or other disposition of such property.

See sec. 1.611-2(a), Income Tax Regs.

[6] SEC. 613. PERCENTAGE DEPLETION.

(a) General Rule.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for deple-

entitled to use either method, the method allowing the greater deduction for any given tax year must be used to compute depletion for that year. Secs. 1.611-1(a) and 1.613-1, Income Tax Regs.

Prior to 1975, it was well settled that the recipient of advance royalties (i.e., royalties paid in advance of the actual production of a mineral) under an oil and gas lease was entitled to compute depletion on the basis of both the cost method and the percentage method and to deduct the greater of the two amounts so computed. See, e.g., *Herring* v. *Commissioner*, 293 U.S. 322 (1934). Effective for taxable years beginning after December 31, 1974, however, the Tax Reduction Act of 1975, Pub. L. 94-12. 89 Stat. 26, added a new section, section 613A, and related provisions which, with certain exceptions, generally eliminated percentage depletion in the case of oil and gas wells.[7] One of the exceptions, on which petitioners rely, provides a limited exemption for independent producers and royalty

> tion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). * * * In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.
>
> * * *

But see sec. 613A regarding the percentage depletion allowance for oil and gas wells.

[7] SEC. 613A. LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS.

> (a) General Rule.—Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613 [i.e., without regard to percentage depletion].
>
> * * *

See also sec. 613(d), providing as follows:

> (d) Denial of Percentage Depletion in Case of Oil and Gas Wells.—Except as provided in Section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section.

owners. Sec. 613A(c).[8] Under this exception, the deduction of percentage depletion continues to be permitted "with respect to * * * so much of the taxpayer's average daily

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[8] Sec. 613A(c) provides in part as follows:

> (c) Exemption for Independent Producers and Royalty Owners.—
>
> (1) In general.—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—
>
> (A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and
>
> (B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;
>
> and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.
>
> (2) Average daily production.—For purposes of paragraph (1)—
>
> (A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and
>
> (B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.
>
> In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary or his delegate).
>
> (3) Depletable oil quantity.—
>
> (A) In general.—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

production" of domestic crude oil or natural gas as does not exceed the taxpayer's "depletable quantities" of crude oil and natural gas.

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) Phase-out table.—For purposes of subparagraph (A)—

In the case of production during the calendar year:	The tentative quantity in barrels is
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(4) Daily depletable natural gas quantity.—For purposes of paragraph (1), the depletable natural gas quantity of any taxpayer for any taxable year shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have this paragraph apply. The taxpayer's depletable oil quantity for any calendar year shall be reduced by the number of barrels with respect to which an election under this paragraph applies. Such election shall be made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

(5) Applicable percentage.—For purposes of paragraph (1)—

In the case of production during the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

* * *

A taxpayer's "average daily production" of domestic crude oil or natural gas is determined by dividing his aggregate production[9] during the taxable year by the number of days in such taxable year. Sec. 613A(c)(2)(A). Under section 613A(c)(3), the taxpayer's depletable oil quantity is equivalent to a specified "tentative quantity," stated in terms of a certain number of barrels of oil "production during the calendar year," reduced by the taxpayer's average daily secondary or tertiary production of domestic crude oil and natural gas[10] for the "taxable year."[11] The taxpayer's depletable natural gas quantity is equal to the number of barrels of his depletable oil quantity that he elects to convert to depletable natural gas quantity,[12] and the taxpayer's depletable oil quantity is reduced by the number of barrels for which he has made such an election.[13]

The number of barrels constituting the taxpayer's tentative depletable oil quantity is set forth in a "Phase-out table" in section 613A(c)(3)(B). The number of barrels in this table is gradually reduced in the case of "production during

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[9] In the case of a taxpayer holding a partial interest in the production of oil and gas from any property, his production for purposes of sec. 613A(c) is to be "determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property." Sec. 613A(c)(2)(B).

[10] Separate provisions are made for the allowance of percentage depletion on secondary or tertiary production of domestic crude oil and natural gas. See sec. 613A(c)(6).

[11] Under sec. 613A(c)(2), a taxpayer's average daily production is determined with reference to his aggregate production during the "taxable year." However, the phase-out table in sec. 613A(c)(3) prescribing the tentative number of barrels in the taxpayer's depletable oil quantity, as well as the table in sec. 613A(c)(5) specifying the percentage to be used in computing percentage depletion, is keyed to the "calendar year." Thus, if a taxpayer is on a fiscal year, "each portion of such taxable year which occurs during a single calendar year shall be treated as if it were a short taxable year." Sec. 613A(c)(10).

[12] Under sec. 613A(b), which is not pertinent here, certain domestic gas wells are exempt from the repeal of percentage depletion in the case of oil and gas. Natural gas that is exempt under sec. 613A(b) is not to be taken into account in determining a taxpayer's depletable natural gas quantity under sec. 613A(c). Sec. 613A(c)(11).

[13] For purposes of this election, 6,000 cubic feet of natural gas is equivalent to 1 barrel of oil. Sec. 613A(c)(4).

the calendar year" from 2,000 barrels in 1975 to 1,000 barrels in 1980 and thereafter. In this connection, section 613A(c)(5) sets forth a table of percentages that are applicable in computing the percentage depletion allowance in the case of "production during the calendar year." The percentage to be used gradually declines from 22 percent in 1975 to 15 percent in 1984 and thereafter.

Respondent, in this case and in proposed regulations under section 613A(c), has taken the position that the exemption for independent producers and royalty owners does not allow percentage depletion on advance royalties paid under an oil and gas lease except to the extent that they are earned or "recouped" through actual production of oil or gas during the taxable year in which the advance royalties are received.[14] In support of his position, respondent emphasizes the language in section 613A(c)(1) stating that the allowance for depletion under section 611 shall be computed in accordance with section 613 only "with respect to * * * so much of the taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed the depletable oil and natural gas quantities specified in section 613A(c)(3) and (4). Respondent reasons that petitioners, having *no* "average daily production" of oil or natural gas for 1975, have nothing with respect to which percentage depletion may be computed in accordance with section 613.

Petitioners, on the other hand, emphasize that percentage depletion was allowable with respect to advance royalties prior to the enactment of section 613A, notwithstanding the absence of production of oil or gas during the year of receipt of such payments. They point out that the depletion allowance has always been "based on the *proceeds* derived from the property" and argue that, therefore, "no *quantity* of oil or gas is required for purposes of the calculation." Petitioners contend that the quantities of

[14] See sec. 1.613A-3(a)(4), examples 4 and 5, Prop. Income Tax Regs., 42 Fed. Reg. 24281 (1977). The proposed regulations provide that percentage depletion is allowable under sec. 613A(c) only with respect to gross income attributable to oil and gas produced in a prior or current taxable year. See sec. 1.613A-7(f), Prop. Income Tax Regs., 42 Fed. Reg. 24287 (1977).

production specified in section 613A(c) were simply intended to limit the applicability of the exemption for independent producers and royalty owners to those producers and royalty owners with production levels below the ceiling quantities and that prior law was to be retained in full with respect to that class of persons.[15] Thus, petitioners maintain that "zero [production] is within the limitation just as is one drop of oil or one cubic centimeter of natural gas" and that, therefore, they are entitled to compute percentage depletion on the advance royalties in 1975.

We hold that petitioners are not entitled to deduct in 1975, a year in which they had no production of oil or gas, percentage depletion computed with reference to their $7,600 in advance royalties. Petitioners may deduct only cost depletion with respect to that sum, and they have made no claim to such a deduction.

As petitioners point out, the amount of the percentage depletion allowance under section 613(a) was computed prior to the enactment of section 613A(c) on the basis of the "gross income from the property," without regard to quantities of production. Nevertheless, section 613A(c) now imposes limitations on the percentage depletion allowance in terms of quantities of production and, as we read it, permits the computation of percentage depletion only with respect to gross income attributable to what might be called an exempt quantity of crude oil or natural gas production. Therefore, unless gross income can be identified as

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[15] Petitioners rely heavily on the following portion of the Conference Committee Report on the Tax Reduction Act of 1975, Conf. Rept. No. 94-120, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 624, 629-630:

> *Senate amendment.*—Under the Senate amendment, the deduction for percentage depletion is generally eliminated with respect to oil and gas produced on or after January 1, 1975, with certain exceptions. These include the exceptions provided under the House bill. In addition, the Senate amendment *retains percentage depletion* at 22 percent on a permanent basis for the small independent producer to the extent that his average daily production of oil does not exceed 2,000 barrels a day, or his average daily production of natural gas does not exceed 12,000,000 cubic feet. Where the independent producer has both oil and natural gas production, the exemption must be allocated between the two types of production. [Emphasis added.]

attributable to an exempt quantity of production (which, of course, can hardly be done in the case of payments received in advance of production), the computation of percentage depletion is not permitted.

In our view, the express language of section 613A(c) limiting the percentage depletion deduction to stated quantities of production is so clear that it permits no other reasonable interpretation. Section 613A(c)(1) allows percentage depletion only with respect to a limited amount of the taxpayer's "average daily production." As previously noted, the taxpayer's "average daily production" is to be determined by dividing his aggregate production by the number of days in "the taxable year"; if there has been no aggregate production, there can be no "average daily production" and percentage depletion is not, therefore, allowable.

Further support for this conclusion is found in the table in section 613A(c) specifying the tentative number of barrels in a taxpayer's "depletable oil quantity" (to which the "depletable natural gas quantity" is keyed) and in the table specifying the declining applicable percentage to be used in computing the percentage depletion deduction. Both tables refer to "production during the calendar year." Sec. 613A(c)(3) and (5). Given this statutory language, we think it clear that percentege depletion is allowable under section 613A(c) in a taxable year only if oil or natural gas has been produced, and the amount of the deduction must be computed by reference to the taxpayer's "average daily production," the depletable oil and natural gas quantities, and the applicable rates set forth in section 613A(c)(5) for the calendar year of production.[10] Because petitioners had no "average daily production" in 1975, they are not entitled to percentage depletion with respect to the advance royalties of $7,600 received in that year.

Petitioners' position that section 613A(c) retains prior law for independent producers and royalty owners, "so long as the quantities applicable to the exemption are not exceeded," is without merit. Section 613A(c) does not impose

[10] See footnote 11, *supra*.

a production ceiling for the purpose of distinguishing a class of taxpayers entitled to the benefits of the exemption from those who are not. Independent producers and royalty owners having average daily production in excess of the statutorily prescribed depletable oil or natural gas quantities *are* entitled to use percentage depletion. The effective rate per unit of oil or gas is modified for those who have production in excess of their depletable quantities,[17] see sec. 613A(c)(7);[18] but independent producers and royalty owners are not denied percentage depletion deductions merely because they have oil or gas production in excess of the depletable quantities. Only those persons who are

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[17] In this connection, see and compare L. Bravenec, "Continued Availability of Percentage Depletion on Oil and Gas," 23 Oil and Gas Tax Quarterly 204, 215-216 (1974-1975), with T. Englebrecht and R. Hutchins, "Percentage Depletion Deductions for Oil and Gas Operations: A Review and Analysis," 56 Taxes 48, 54 (1978).

[18] Sec. 613A(c)(7) provides as follows:

(7) Special Rules.—

(A) Production of crude oil in excess of depletable oil quantity.—If the taxpayer's average daily production of domestic crude oil exceeds his depletable oil quantity, the allowance under paragraph (1)(A) with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613(a) for all of the taxpayer's oil produced from such property during the taxable year (computed as if section 613 applied to all of such production at the rate specified in paragraph (5) or (6), as the case may be) as his depletable oil quantity bears to the aggregate number of barrels representing the average daily production of domestic crude oil of the taxpayer for such year.

(B) Production of natural gas in excess of depletable natural gas quantity.—If the taxpayer's average daily production of domestic natural gas exceeds his depletable natural gas quantity, the allowance under paragraph (1)(B) with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613(a) for all of the taxpayer's natural gas produced from such property during the taxable year (computed as if section 613 applied to all of such production at the rate specified in paragraph (5) or (6), as the case may be) as the amount of his depletable natural gas quantity in cubic feet bears to the aggregate number of cubic feet representing the average daily production of domestic natural gas of the taxpayer for such year.

* * *

"retailers" or "refiners" (or persons related to "retailers" or "refiners"), as those terms are defined in section 613A(d), are excluded from the class of taxpayers entitled to the benefits of the exemption.

Nor does the language in the Conference Committee Report, quoted in footnote 15, *supra*, to the effect that the Senate version of the bill "retains percentage depletion" for the small independent producer, aid petitioners' cause. That language was clearly intended to refer to the fact that, under the Senate version, the 22-percent rate for percentage depletion was to be retained on a permanent basis in connection with the exemption for independent producers. It was not the Senate version of the bill, but a Conference substitute, that was enacted into law. The Conference Report makes it plain that, although the Conference substitute followed the Senate version by providing a limited exemption for independent producers,[19] the exemption was to be gradually phased down both in terms of the exempt quantity of production and the rate to be applied in computing percentage depletion. Conf. Rept. No. 94-120, 94th Cong., 1st Sess., 1975-1 C.B. 624, 630. The Conference Report does not, as petitioners urge, indicate that prior law was to be retained in full for a certain class of producers and royalty owners.[20]

Section 613A(c)(1) does state, however, that "the allowance for depletion under section 611 shall be computed *in accordance with section 613* [emphasis added]" with respect to so much of the taxpayer's average daily production of oil or gas as does not exceed his depletable quantities. Section

[19] The House version of the bill contained no exemption for independent producers and royalty owners.

[20] Aside from the Conference Report cited above, which itself does not adequately explain the complex provisions of sec. 613A(c), the legislative history is quite sketchy. Sec. 613A was introduced as a Senate floor amendment, and as a result the provision was not considered in either the House Report (H. Rept. No. 94-19, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 569) or the Senate Report (S. Rept. No. 94-36, 94th Cong., 1st Sess (1975), 1975-1 C.B. 590) on the bill leading to the Tax Reduction Act of 1975. Similarly, the substance of the debates with respect to the exemption for independent producers and royalty owners is of little assistance in interpreting the provisions of sec. 613A(c).

613(a)[21] provides that, in computing percentage depletion, the measure of the deduction is a specified percentage of the "gross income from the property." Further, section 613(a) provides that the allowance shall not exceed 50 percent of "the taxpayer's taxable income from the property (computed without allowance for depletion)."

A large body of law was developed under section 613(a) as to the meaning of "gross income from the property" in relation to oil and gas wells. Extensive regulations have been issued to define the phrase "taxable income from the property" as used in section 613.[22] That section, its predecessors, and the regulations have been the subject of numerous Revenue Rulings and court opinions on how the "gross income from the property" and "taxable income from the property" are to be computed.[23] We think the language in section 613A(c) to the effect that the percentage depletion allowed to indepedent producers and royalty owners "shall be computed in accordance with section 613" means simply that the computation is to follow the principles already developed for computing percentage depletion for oil and gas, subject, of course, to the provisions of section 613A. Thus, percentage depletion under section 613A(c) is to be computed with reference to the "gross income from the property" *attributable to* the exempt portion of a taxpayer's "average daily production," but the allowance is limited to 50 percent of the "taxable income from the property."

It is true that, as petitioners emphasize, the Supreme Court in *Herring* v. *Commissioner*, 293 U.S. 322, 328 (1934), rejected the contention that some production of oil or gas was a prerequisite to the allowance of percentage depletion on a lease bonus or advance royalty received upon the execution of an oil and gas lease. The basis for this holding was that bonuses and advance royalties are not capital gains but "payment[s] in advance for oil or gas to be

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[21] See footnote 6, *supra*.

[22] Sec. 1.613-5, Income Tax Regs.

[23] See the discussion entitled "Taxable Income from the Property for Depletion Purposes" in Miller's Oil and Gas Federal Income Taxation, ch. 10 at 145 (J. Houghton ed. 1980).

extracted, and * * * [are] therefore taxable income." *Herring* v. *Commissioner*, *supra* at 324. However, the statute there involved (the predecessor of section 613) made "gross income from the property," without qualification, the case for computing percentage depletion.[24] The Court did not have before it the subsequently enacted provisions of section 613A(c) allowing percentage depletion, as we have discussed above, only with respect to the exempt portion of a taxpayer's average daily production of crude oil or natural gas. Under section 613A(c), where there has been no production during the taxable year of receipt, percentage depletion is not allowable in that year with respect to advance royalties paid under an oil and gas lease.

Of course, actual production of oil or gas at some point in time has always been an implicit requirement of the allowance for depletion under either the cost or the percentage method.[25] However, we do not think, as petitioners appear to contend, that income from possible production in a future year will suffice for the purposes of section 613A(c). In effect, this would mean that "production" as used in section 613A(c) should be read to mean "sales of future production."[26] There is no legislative history or discernible legislative purpose that will support such a rewriting of the statutory language.

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[24] Even so, if there was no production of oil or gas prior to the cancellation of the lease (i.e., no actual depletion), the taxpayer was required to restore the previously deducted depletion to income. *Douglas* v. *Commissioner*, 322 U.S. 275, 285 (1944); *Sneed* v. *Commissioner*, 119 F.2d 767, 711 (5th Cir. 1941), affg. 40 B.T.A. 1136 (1939), cert. denied 314 U.S. 686 (1942).

[25] See footnote 24, *supra*, and sec. 1.612-3(a)(2) and (b)(2), Income Tax Regs.

[26] See M. Backus, "A Stitch in Time Necessary to Save Lease Bonus Depletion," 55 Taxes 313 (1977); L. Bravenec, "Continued Availability of Percentage Depletion on Oil and Gas," 23 Oil and Gas Tax Quarterly 204, 211 (1974-1975) (while contending that "production" as used in sec. 613A(c) should be interpreted as meaning "sales," the author notes that it "is difficult to sustain * * * [such a] construction by reference to the statutory language").

Section 613A(c) does not refer merely to production in general, but to a taxpayer's aggregate production "under the taxable year." In prescribing the depletable quantities, the section specifies a quantity of oil measured in "barrels" of "production during the calendar year" and a quantity of natural gas measured by reference to "barrels" of oil and "cubic feet" of gas. The section also makes important distinctions that depend on the type of production, i.e., oil versus natural gas, and the method of production, i.e., primary versus secondary or tertiary. Sec. 613A(c)(6) and (7). It is difficult to conceive what language Congress could have chosen to state more clearly a requirement tying the allowance of percentage depletion to the actual production of oil or gas on an annual basis.

Finally, numerous practical problems would arise in the application of section 613A(c) if production were interpreted to include royalties received in advance of production. When advance royalties are received upon the execution or assignment of a lease, the lessor may not know what mineral will be discovered or (in some cases) what method of recovery will be required to produce it. As pointed out above, the section prescribes different formulae for computing a taxpayer's "depletable oil quantity" and a taxpayer's "depletable natural gas quantity." Section 613A(c)(6) prescribes an entirely separate set of rules with respect to the allowance of percentage depletion on secondary and tertiary production. If a taxpayer has "excess production" during the taxable year, he must allocate the taxable income from the property between oil and gas production. Sec. 613A(c)(7). It should also be noted that section 613A(b)(2), as amended by the Energy Tax Act of 1978,[27] allows percentage depletion at the rate of 10 percent with respect to "any qualified natural gas from geopressured brine." Thus, if the term "production" as used in section 613A(c) is read so as to include income from the production of future years, there may be no way to determine at the time such income

[27] Pub. L. 95-618, 92 Stat. 3204 (Nov. 9, 1978). The amendment applies to natural gas produced from geopressured brine and "which is produced from any well the drilling of which began after September 30, 1978, and before January 1, 1984."

is received whether the section 613A(b) and (c) limitations on oil, gas, primary or (in some situations) secondary production, or natural gas from geopressured brine would apply.

In our view, the fact that section 613A(c) was written into the Internal Revenue Code as a limited exception to the general repeal of percentage depletion for oil and gas militates against giving that section an expansive and extraordinary interpretation. Given the language of the statute and the absence of any legislative history indicating that the statute does not mean what it says, percentage depletion may not be deducted except with respect to exempt quantities of production. In the case of royalties paid in advance of production, the statutes here applicable limit the taxpayer to a deduction for cost depletion.

To reflect the foregoing,

Decision will be entered for the respondent.[28]

Reviewed by the Court.

NIMS, *J.*, did not participate in the consideration or disposition of this case.

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[28] See *Glass* v. *Commissioner*, 75 T.C. ____ (1981), filed this day.

GOFFE, *J.*, concurring: I wholeheartedly concur, not only in the result, but also in the rationale of the majority opinion, which, contrary to the complaint in Judge Fay's dissent, clearly explains why percentage depletion is not allowable against advance royalties which are not attributable to actual, existing production. Though I am inclined to pinpoint some of the aspects of our discourse on the thorny problems posed by section 613A, Internal Revenue Code of 1954,[1] I am moved to write this concurrence primarily because the dissenting opinion by Judge Fay suffers greatly from flaws of construction and oversights in application.

The majority's recitation of the historical treatment of advance royalties for percentage depletion purposes, as well as its explanation of the basic provisions of section 613A, needs no elaboration. It is undisputed that, prior to the enactment of section 613A, percentage depletion was allowable on advance royalties received, whether they were to be recouped against future production or not. However, who can deny that the 1975 legislation drastically reduced allowable percentage depletion? By dint of the construction of the disallowance, it is now the exception, rather than the rule, when percentage depletion is allowable.

At the outset, it should be pointed out that the 1975 revision to the previously existing percentage depletion scheme is a drafting nightmare. The denial contained in the cross-referencing of section 613(d), the almost-total denial contained in section 613A(a), and the exemption contained in and the cross-referencing of section 613A(c)(1), combine to provide a maze through which we must now approach the percentage depletion deduction. Furthermore, the controlling statute, as amended, fails to directly address not only the issues before us, but also raises multiple collateral issues which we are not asked to decide in this case. It is doubtful whether even reasonable regulations, if such

[1] All section references are to the Internal Revenue Code of 1954, as amended.

regulations are forthcoming from the Commissioner, can completely unscramble the present version of this item of "legislative grace."

The majority opinion has, in my view, taken a mangled statute that is unattended by any germane or informative legislative history and has interpreted it by a direct and simple construction of one of the least ambiguous words in the statute: production. Repeated readings of sections 611, 612, 613, and 613A lead me to the conclusion that percentage depletion, to the extent allowable at all, can be obtained only with respect to a limited quantity of actual production (oil or gas extracted from the ground) per year. The year of extraction controls the number of barrels of production with respect to which percentage depletion is allowable (such must be the necessary implication of a yearly depletable oil quantity—see section 613A(c)(3)), and it is that same year that determines the appropriate percentage to be applied to such barrels (such is the logical implication of the columnar heading in section 613(c)(5) which states "In the case of production during the calendar year").

Judge Fay's dissenting opinion focuses almost entirely upon situations where extraction and payment for the extracted hydrocarbon occur in different taxable years. This is the exception rather than the commonplace situation. It is even more exceptional in the case of royalty owners than independent producers. Normally oil or gas is sold in the taxable year in which it is extracted and the matching of the income with the allowable percentage depletion is simple.

If, for some reason, payment for the hydrocarbon is received in a calendar year subsequent to the year of extraction, we must determine in which taxable year, if either, the taxpayer is entitled to percentage depletion. This question is answered in section 1.613A-3(a)(4), Example 7, Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 3, 1977) as follows:

Example (7). H, a calendar year taxpayer, owns a domestic oil well which produced 100,000 barrels of oil in 1975. The proceeds from the sale of 15,000 barrels of that production are not includible in H's income until 1976. The

15,000 barrels produced in 1975 are included in H's average daily production for 1976 and excluded from such production for 1975.

At first blush the example appears reasonable. It merely provides for tracing the income from the oil extracted and applying the barrels produced to the taxable year the income is received. Because of the two new major ingredients introduced into the allowable percentage depletion deduction by the 1975 amendment, I conclude that the method is not fair. The 1975 revision to the percentage depletion deduction established an annual limitation on the deduction which varies for different calendar years from 1975 to 1980 and it also specified a variable percentage allowable for different calendar years from 1980 to 1984. Because of these variables, it makes a substantial difference as to which taxable year one refers in allowing percentage depletion on hydrocarbon income derived from the sale of production extracted in an earlier taxable year.

The majority clearly holds that the intent of the statute is to allow the percentage depletion deduction for hydrocarbons "produced." "*Production*" *means extraction.* No one familiar with the "oil business" would seriously question such a definition of "production." Because the focus of the percentage depletion deduction is on production (or extraction), in my view that identification should be preserved if payment for the hydrocarbon fortuitously fails to coincide with extraction in the same calendar year. The barrel limitation expressed as average daily production in section 613A(c)(2) refers to the taxpayer's "production" for any taxable year; the phase-out table in section 613A(c)(3)(B) is headed "In the case of production *during* [emphasis added] the calendar year"; and in section 613A(c)(5) the heading for the applicable percentage for specified calendar years reads, "In the case of production *during* [emphasis added] the calendar year." Because these limitations (barrel limitation and percentage allowable) are unmistakably defined in terms of production during the year, the income from all qualifying production in that year should be subject to percentage depletion regardless of the year of payment for that production. I would apply that rationale to Example

(7) above by holding that the 15,000 barrels of oil produced in 1975 would be entitled to percentage depletion of 22 percent regardless of the percentage allowable in the year the oil is sold. If the years were instead 1980 (year of extraction) and 1981 (year of sale), I would allow 20 percent depletion on the 15,000 barrels rather than 18 percent.

As to the barrel limitation on the 15,000 barrels, I would also look to the year of extraction rather than a subsequent year of sale.

To illustrate this concept, let us assume that the taxpayer had 380,000 barrels of production in 1981 of which 25,000 barrels were not sold until 1982. I would allow no percentage depletion on the 25,000 barrels sold in 1982 because in the year of extraction the taxpayer exceeded the 365,000 barrel limitation.

Let us assume instead that the taxpayer had only 365,000 barrels of production in 1981, all of which were sold in 1981 except 30,000 barrels, which were sold in 1982. Assume further that in 1982 the taxpayer extracted 365,000 barrels. Because the oil extracted in 1981, including the 30,000 barrels sold in 1982, did not exceed the taxpayer's limitation of 365,000 barrels when extracted, he should be entitled to percentage depletion on the proceeds from the sale of such oil in 1982 and he should be allowed percentage depletion at the rate of 20 percent (allowable for 1981) rather than 18 percent (allowable for 1982).

Although I have referred, for the sake of clearity, to specific barrels being extracted in one year and sold in the next, I recognize that a literal tracing of barrels of oil (or cubic feet of gas) would present a record-keeping nightmare. However, such tracing is unnecessary. By taking a cue from normal first-in, first-out inventory accounting, it is fairly easy to devise a system whereby the appropriate percentage depletion allowable with respect to production extracted in a given taxable year and sold in a subsequent taxable year can be determined on the basis of the amount of extraction, the tentative quantity, and the applicable percentage for such taxable year. Any unsold production from a taxable year can be "inventoried," by recording not only the amount remaining unsold but also the appropriate

percentage by which the proceeds from the sale of such production will be multiplied when it is eventually sold to arrive at allowable percentage depletion. Working from the assumption that the first oil or gas sold in a taxable year is the oldest oil or gas in inventory, all of the allowable percentage depletion will eventually be matched with the proceeds from the sale of the production which qualified for percentage depletion.

The following example illustrates this procedure: assume extraction and sales of oil (at an assumed price of $10 per barrel) in these amounts for the calendar years 1981 through 1983:

	1981	*1982*	*1983*
Extraction (in barrels)	1,460,000	365,000	36,500
Sales (in barrels)	730,000	365,000	766,500
Sales (in dollars)	$7,300,000	$3,650,000	$7,665,000

We should note that, in reality, the percentage depletion limitations are not imposed by applying the applicable percentage to a limited amount of barrels (though that is the effect and basic concept of the scheme), but rather such limitations are imposed by reducing the percentage applied to *all* barrels. Sections 613(a), 613A(c)(1), (5) and (7). For purposes of this example, I will refer to this percentage which is actually applied to all production income (which percentage may be equal to or less than the relevant applicable percentage specified in section 613A(c)(5)) as the "percentage depletion fraction" (PDF).

According to section 613A(c)(1), if a taxpayer's average daily production (ADP) is less than or equal to his depletable oil quantity (DOQ), the PDF equals the applicable percentage (AP) set forth in section 613A(c)(5). If, however, a taxpayer's ADP is greater than his DOQ, his PDF equals the AP multiplied by a fraction the numerator of which is the DOQ and the denominator of which is the ADP. Thus, in our example, the PDF for each year is as follows:

	1981	*1982*	*1983*
ADP[a]	4,000	1,000	100
DOQ[b]	1,000	1,000	1,000
AP[c]	.20	.18	.16
PDF[d]	.05	.18	.16

a—APD = Total production divided by number of days in the taxable year. Sec. 613A(c)(2)(A).

1981 = 1,460,000 ÷ 365 = 4,000
1982 = 365,000 ÷ 365 = 1,000
1983 = 36,500 ÷ 365 = 100

b—Sec. 613A(c)(3).

c—Sec. 613A(c)(5).

d—Because ADP is greater than DOQ in 1981,

PDF = (DOQ ÷ ADP) x .20 = (1,000 ÷ 4000) x .20 = .05.

In 1982 and 1983, ADP is less than DOQ, so PDF = AP.

All oil extracted in those years should eventually be depleted at the PDF rate applicable to the year of such extraction, regardless of when sold. If that occurs, the total percentage depletion allowed would be as follows:

	1981	*1982*	*1983*	*Total*
Extraction	1,460,000	365,000	36,500	
Times Sales Price	x $10	x $10	x $10	
Gross Income	$14,600,000	$3,650,000	$365,000	
Times PDF	x .05	x .18	x .16	
TOTAL % DEPLETION	$ 730,00	$ 657,000	$ 58,400	$ 1,445,400

Mechanically, each year's percentage depletion deduction (assuming that the 50 percent of taxable income from the property limit is not exceeded) would be computed as follows:

1981—Total sales—730,000 barrels
PDF x (barrels sold x price per barrel)
.05 x (730,000 x $10)
.05 x $7,300,000
$365,000—1981 percentage depletion

Inventory (in barrels)—Beginning	-0-
Extracted[a]	1,460,000 @ .05
Subtotal	1,460,000 @ .05
Sold	(730,000 @ .05)
Ending	730,000 @ .05

1982—Total sales—365,000 barrels
PDF x (barrels sold x price per barrel)
.05 x (365,000 x $10)[b]
.05 x $3,650,000
$182,500—1982 percentage depletion

Inventory	—Beginning	730,000 @ .05
	Extracted	365,000 @ .18
	Subtotal	730,000 @ .05
		365,000 @ .18
	Sold	(365,000 @ .05)[b]
	Ending	365,000 @ .05
		365,000 @ .18

1983—Total sales—766,500 barrels
PDF x (barrels sold x price per barrel)
[.05 x (365,000 x $10)] + [.18 x (365,000 x $10)] + [.16 x (36,500 x $10)]
(.05 x $3,650,000) + (.18 x $3,650,000) + (.16 x $365,000)
$182,500 + 657,000 ;ol 58,400
$897,900—1983 percentage depletion

Inventory	—Beginning	365,000 @ .05
		365,000 @ .18
	Extracted	36,500 @ .16
	Subtotal	365,000 @ .05
		365,000 @ .18
		36,500 @ .16
	Sold	(365,000 @ .05)
		(365,000 @ .18)
		(36,500 @ .16)
	Ending	-0-

Thus the cycle is complete. Note that the total percentage depletion arrived at in these detailed calculations ($365,000 + $182,500 + $897,900 = $1,445,000) equals the amount calculated at the outset of this example, *supra* at page 8. No actual physical tracing of extraction is needed because this inventory-type method will accomplish the results sought by my interpretation of the statute. Some may quibble that the assumption of a constant price of oil invalidates this example. On the contrary, if prices rise or fall the above-outlined method will result in percentage

a—Must note the PDF previously calculated for production extracted that year.
b—Use FIFO to determine what barrels were sold, and, therefore, which PDF to use.

depletion calculated on the basis of the actual "gross income from the property" in the year the extraction is sold, which result dovetails nicely with the general percentage depletion formula in section 613(a). The allowability, as well as the appropriate rate, of percentage depletion is determined as of the taxable year of extraction, as it should be.

Although I speculate as to whether the Commissioner may, by regulation, establish such a scheme when the statute does not specifically authorize it, the question apparently does not disturb the Commissioner because he has proposed, also without statutory mandate, his own brand of carryforward set forth above. That being the case, I would urge the commissioner, who has just prevailed in the instant case as to advance royalties and in *Glass v. Commissioner*, 76T.C. ___ (June 8, 1981), as to lease bonuses, to re-examine his proposed regulations (which have been proposed since 1977) in light of the opinions in these two cases in order to make them more compatible with the statute as amended in 1975. Surely our holdings in these two cases should encourage the Commissioner to re-examine the proposed regulations and attempt to finalize them in a form that correctly interprets the statute. Hope springs eternal that such an admonition will be heeded.

My proposal, which I contend is far from the characterization of "impossible" (dissenting opinion, *infra* at 50, fn. 6), easily conforms with the general requirements of section 613(a), a section which the dissent over and over ... and over ... abjures us not to neglect, that the deduction is allowable by taking a percentage of the gross income from the property.

Having said all this, it is easy to see the most glaring flaw in the analysis of the dissent. The statute requires a counting of the barrels of production in a taxable year in order to determine what production percentage depletion will be allowed "with respect to" and to determine the applicable percentage "in the case of production during the calendar year." Sec. 613A(c)(5). One cannot count barrels of production that do not yet, and may never, exist. When a taxpayer receives an advance royalty no one knows whether hydrocarbons will be extracted from that property. A

cursory examination of newspaper accounts of drilling activity readily demonstrates the folly of concluding that production will necessarily follow receipt of an advance royalty. As the majority points out so clearly on pages 23-26 of its opinion, the problems of statutory construction and obvious practical problems of imputing possible future production into a present-year calculation under new section 613A are insurmountable.

Similarly I, like the majority, am convinced that *Herring v. Commissioner*, 293 U.S. 322 (1934), provides little guidance here because of the drastic changes in the law made subsequent to that decision. No matter how many times the dissent proclaims that we are undermining the holding in *Herring*, the fact of the matter is that *Herring* simply does not apply. Just as the *Cohan* rule became largely irrelevant in the travel and entertainment expense context after the enactment of section 274, the *Herring* decision no longer holds complete sway in the percentage-depletion-on-advance-royalty context after the 1975 enactment of sections 613(d) and 613A.

The chant found throughout Judge Fay's dissenting opinion is that because section 613A(c)(1) provides that the allowance for depletion under section 611 "shall be computed in accordance with section 613," production has to have some relation to gross income. In such incantations, he continually states the obvious while overlooking the stated, i.e., that percentage depletion is now allowed only with respect to a limited amount of actual production. Of course, because percentage depletion is derived by multiplying gross income from the property by the applicable percentage, production must have some relation to gross income. Thus, only gross income attributable to the sale of so much of a taxpayer's average daily production as does not exceed his depletable quantity is now eligible for percentage depletion. The now-extant sections controlling this deduction do not speak to the timing of the deduction, except that section 613(a) requires that there be some gross income from the property in a taxable year as a necessary precondition to having something to multiply by the applicable percentage. Production limits the amount of the deduction; *ergo* in

order to compute the percentage depletion deduction for a taxable year, it is necessary to have had some actual production before or during such taxable year in order to qualify some barrels under section 613A(c), the proceeds from the sale of which constitute the gross income of which section 613(a) speaks. When the dissent starts from the above-stated proposition that production and income must be related, and reasons to the conclusion that hypothetical future production will somehow support a present percentage depletion deduction, it has engaged in a brand of deductive sophistry which I am loath to embrace.

Thus, I fully support the holding and rationale of the majority opinion. Though the author of that opinion did not need to extend its legal reasoning as far as I have in order to dispose of the issue before us, it is apparent that much of what I have outlined above is the necessary implication of the holding embodied in the majority opinion. Moreover, I agree that an alternative holding based upon a theory such as that found in the dissenting opinion would produce numerous practical problems, as outlined in the majority opinion at pages 24 and 25. The dissent's attempt to address these problems is feeble. (See dissenting opinion, *infra*, at p. 60 fn. 15). Since 6,000 cubic feet of gas may not sell for the same price as a barrel of oil, the need to know the make-up of the production is critical, particularly where there is "excess production." Secs. 613A(c)(7)(A) and (B). In addition, it will be the exception, rather than the rule, when a taxpayer knows, at the time an advance royalty or bonus is paid, whether secondary or tertiary recovery methods will be necessary or economically feasible. Furthermore, the dissent never addresses this obvious question: if an unrecouped advance royalty represents production in the year of receipt, how would one convert the raw dollar amount received into a quantity of barrels for purposes of determining the taxpayer's average daily production under section 613A(c)? How many dollars equal a barrel of oil, or, for that matter, 6,000 cubic feet of gas? The practical problem surely exists, even though the dissent does not, by reason of the small amount here involved, feel compelled to address it.

The dissent's strident examples prove nothing. Under the majority's approach, which has the virtue of interpreting the word "production" in its ordinary, everyday sense, *Malat v. Riddel*, 383 U.S. 569 (1966), the otherwise allowable percentage depletion on advance royalties recoupable against future production which are paid but not recouped in the year of payment will be lost forever. *Quaere* whether or not this is an inequitable result inasmuch as the taxpayer has received, in exchange for risking the loss of otherwise allowable percentage depletion, an advance royalty on production which may never exist.[2] Under the dissent's approach, the same inequitable result suggested by Example (7) of section 1.613A-3(a), Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 13, 1977), will occur, though for a slightly different reason (see discussion, *supra*). The proposed regulation would throw unsold, but otherwise allowable production, into the second year and include it in the average daily production computation, which treatment could produce an average daily production in excess of the allowable depletable quantity in the later year, resulting in partial permanent disallowance of percentage depletion, even though actual production in neither year exceeded the maximum depletable amount. Likewise, the dissent's approach would permanently deprive a similarly situated taxpayer of the same amount of depletion. By looking only at income, and then deriving from that amount the number of barrels represented, the dissent would say that all of the "production" occurred in the later year. Under an example where a taxpayer produced 365,000 barrels in 1981, 365,000 barrels in 1982, and sold all 730,000 barrels in 1982, the dissent's approach would conclude that the average daily production in 1982 is 2,000 barrels. Since the tentative quantity for 1982 is 1,000 barrels, this approach

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[2] A similar result obtains, stresses the dissent, when production is sold prior to extraction. If, in such a highly improbable situation, the well is dry or blows out, and the seller must refund the sales proceeds, then such amounts are mere deposits. If the seller may keep the funds, again I wonder whether or not he has gotten the better end of the trade between money in hand and possible percentage depletion deductions.

would effectively deny percentage depletion on half of the production sold in 1982. Thus, whenever oil is stored from one year to the next (a not uncommon phenomenon for an independent producer), such oil, the proceeds from the sale of which would have been subject to percentage depletion had such oil been sold when extracted, quite likely will not be subject to percentage depletion when sold in a later year, and an extremely "harsh result obtains" (see dissent at pp. 51-52). It is apparent that examples can be marshalled to show the inequity of any construction of this statute. Thus, once again, I am content to follow the majority's simple, but not simplistic, interpretation of the term production.

I would like to turn briefly to other problems presented by the construction and application of sections 611 through 614.

It can hardly be denied that the rationale of the majority, when applied to the question of whether percentage depletion on lease bonuses remains available, requires a negative answer to such question. See *Glass v. Commissioner*, 76 T.C. ___ (June 8, 1981). Though percentage depletion was available to a lessor with respect to lease bonuses received prior to the 1975 change in the law, *Herring v. Commissioner*, *supra*, under the rationale of the majority here and under our decision this day in *Glass v. Commissioner*, *supra*, the diminution of the reservoir of hydrocarbons represented by the bonus payment is now recoverable only through the use of cost depletion.[3] That being the case, it is questionable whether there remains any reasonable need for the "bonus exhaustion rule" embodied in section 1.613-2(c)(5)(ii), Income Tax Regs. See also *Quintana Petroleum Co. v. Commissioner*, 143 F.2d 588 (5th Cir. 1944). The bonus exhaustion rule required that a lessee, in computing his "gross income from the property" (which is the amount to which the applicable percentage is applied in order to determine the allowable percentage depletion), exclude therefrom a proportionate part of any bonus paid

[3] In a wildcat area, the present treatment of bonuses received may be more advantageous than it would have been prior to 1975. See *Collums v. United States*, 480 F. Supp. 864 (D. Wyo. 1979).

with respect to such property on the theory that, because bonuses were characterized as advance royalties, to allow percentage depletion on both the bonus and on all of the production income from a property would result in double depletion on production income in an amount equal to the bonus paid. Inasmuch as bonuses are no longer subject to percentage depletion, the rationale for that rule no longer exists. See Bravenec & Flagg, "Initial Proposed Section 613A Regulations," 24 Oil & Gas Tax Q. 218, 224 (1975); Burke, "Proposed Regulations Under Section 613A—An Analysis and Critical Review," P-H Oil & Gas/Natural Resources (1976).[4] *Quaere* whether this rationale is also applicable to the unrecouped portion of advance royalties paid. See section 1.613-2(c)(5)(iii), Income Tax Regs.; Rev. Rul. 79-386, 1979-2 C.B. 246.

Another nettlesome problem arises when we consider the situation where a bonus, which is not subject to percentage depletion but should conceivably always be subject to cost depletion, is received in the same year as a royalty (or a recouped advance royalty), which royalty is subject to percentage depletion as limited by section 613A. At first blush, one would think that the recipient would just take cost depletion on the bonus (with regard only to the bonus) as outlined in section 1.612-3(a), Income Tax Regs., then calculate both cost and allowable percentage depletion on the royalty received and, pursuant to sections 1.611-1(a)(1), 1.612-3 (d), and 1.613-1, Income Tax Regs., deduct the greater of the two (subject to basis limitations for the deduction of cost depletion—sec. 1.611-2(b)(2), Income Tax Regs.). However, under my understanding of sections 1.611-1 (a) and 1.613-1, Income Tax Regs., as they presently exist, a taxpayer may deduct, with respect to each "property" (which is defined under section 614(a) as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land"), either cost or percentage depletion in the same taxable year, but

[4] It appears that the Commissioner still clings to the bonus exhaustion rule. See Rev. Rul. 79-78, 1979-1 C.B. 218; I.R.S. National Office Technical Advice Memorandum, written determination No. 8026011 dated March 20, 1980.

not both. Thus, a taxpayer in the above fact situation would be allowed to deduct (subject to section 1.611-2 (b)(2), Income Tax Regs.) only the greater of (1) an amount equal to the sum of cost depletion calculated with regard to the bonus under the formula set forth in section 1.612-3(a), Income Tax Regs., and cost depletion calculated under the formula set forth in section 1.611-2(a), Income Tax Regs., with regard to the royalty (or recouped advance royalty) received during that taxable year, or (2) an amount equal to the percentage depletion allowable under section 613A with respect only to the royalty (or recouped advance royalty) received during that taxable year. Compelling a choice between these two incomplete alternatives does not seem fair, and were I faced with a case requiring a construction of such regulations, I am not sure I could abide such an inequitable result. The controlling regulations were, of course, issued prior to the enactment of section 613A under the statutory mandate of section 611(a) that "there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * * such reasonable allowance in all cases to be made under regulations prescribed by the Secretary * * *." Though such regulations no doubt were reasonable prior to the enactment of section 613A, I question whether they continue to provide a "reasonable allowance for depletion" under the revised legislative scheme for calculating the percentage depletion deduction. I would hope that the Commissioner would promptly propose regulations that would allow a taxpayer to take cost depletion with respect to a bonus received, regardless of whether cost or percentage depletion is higher as to the income from actual production received during the same taxable year.

There are no doubt other technical problems in the percentage depletion area caused by the drastic revision made in 1975. The proposed regulations should be examined not only to resolve the problems I have enumerated above but also to speak to some others which lurk behind the scene. Hopefully the Commissioner will perform a comprehensive review of the proposed regulations.

FAY, *J.*, dissenting: While the grounds upon which the majority opinion rests its holding are unclear, I nevertheless disagree. In my view, advance payments for oil or gas do in fact represent "production" for purposes of section 613A(c).[1]

Section 613A(c)(1) allows percentage depletion with respect to so much of a taxpayer's "average daily production" as does not exceed his "depletable oil quantity." Section 613A(c)(2)(A) defines "average daily production" as "aggregate production" divided by the number of days in the taxable year. The critical word is "production." Unfortunately, the majority opinion makes no attempt to define "production" but cavalierly assumes there was no "production" in this case.[2] See majority, *supra* at 15. Evidently, the majority requires extraction but provides no enlightenment as to whether "production" means only extraction or whether extraction is merely one required element of "production."[3] While I agree that some tie to extraction is essential for percentage depletion, I see no reason why future extraction as well as past or current extraction cannot suffice. See generally, *Herring* v. *Commissioner*, 293 U.S. 322 (1934). I would interpret "production" to mean the extraction (past, current, or future) properly attributable to a taxpayer's taxable year. The number of barrels properly attributable to a year is easily measured by income. This interpretation follows closely what I perceive to be the intent of Congress without leading to inexplicable, illogical results as different factual cases emerge. Whatever interpretation the majority opinion is giving to "production," that interpretation is simply wrong.

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[1] Unless otherwise provided, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

[2] I realize petitioners stipulated they had no "average daily production" of oil or gas; however, it is obvious they were equating "production" with extraction. Therefore, I would not base any denial of petitioners' percentage depletion deduction on that stipulation.

[3] I use the term "extraction" to mean the physical withdrawal of oil or gas.

First, the majority opinion could be read as defining "production" as extraction alone. Thus, the percentage depletion would be allowable only with respect to extraction occurring during the taxable year. While such a definition might come to mind upon a simplistic first reading of the statute, it becomes absurd after further reflection. Reading section 613A(c) as requiring extraction during the taxable year effectively ignores the mandate found in section 613A(c)(1) that allowable percentage depletion be computed "in accordance with section 613."

Section 613(a) grants a deduction calculated by taking a percentage of the gross income from property. Therefore, in order for section 613A(c) to mesh with section 613(a) both logically and administratively, "production" has to have some relation to gross income. See sec. 1.613-3(a), Income Tax Regs. The illogical result which obtains from interpreting section 613A(c) as requiring extraction in the taxable year is illustrated by the following example. Assume these facts: In December 1975, *B*, a cash basis, calendar year taxpayer, extracts 10,000 barrels of oil for which he is paid in 1976.[4] *B* neither extracts nor sells any more oil in 1975 or in 1976. If "production" meant *only* extraction, *B* would have "production" in 1975 but no gross income from the property in that year to serve as a basis for calculating percentage depletion under section 613(a). In 1976, *B* would have gross income from the property but it would not be with respect to any 1976 "production since *B* did not extract any oil in 1976. In effect, *B* would be denied his percentage depletion allowance with respect to all 10,000 barrels. That is obviously not what Congress intended; therefore, I am very hesitant to attribute such reasoning to the majority.

Perhaps the majority opinion would allow our taxpayer, *B*, percentage depletion in 1976 since it is unclear whether it requires extraction in the same year as a percentage

[4] I shall be using examples throughout this dissent. For convenience, I am assuming a "depletable oil quantity" of 1,000 barrels. See sec. 1.613A(c)(3)(B). Thus a taxpayer could have 365,000 barrels of "production" in a calendar year of 365 days without having his "average daily production" exceed his "depletable oil quantity."

depletion deduction is claimed.[5] Respondent, in his proposed regulations under section 613A(c), takes the position that "production" occurs in the year income is received if and only if the income is backed by past or year-of-income extraction. See sec. 1.613A-3(a)(4) example (4), Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 13, 1977).[6] In my example above, *B* would have 10,000 barrels of "production" in 1976 because income from 10,000 barrels was recognized in 1976 under *B*'s method of accounting and because there had been at least 10,000 barrels extracted before or in the same year as the income. Thus, the proposed regulations reach a reasonable result when the income from oil or gas is received with or following extraction. But if income precedes extraction, that is, if advance payment is received, respondent contends there is no "production." That contention produces clearly untenable results.

Consider the following example: During 1975, *C*, a cash basis, calendar year taxpayer, extracts 2,000 barrels and receives income for 3,000 barrels. In 1976, *C* extracts 5,000 barrels and receives income for 4,000 barrels. Those facts are charted below:

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[5] The majority opinion, *supra* at 15, seems to imply an "exempt quantity of production." However, the matter is left unresolved.

[6] It is unclear under the proposed regulations whether, for purposes of determining if the depletable oil quantity has been exceeded, one would look to the income or to the required back-up extraction. Thus if 300,000 barrels were extracted each year for four years, and all 1,200,000 barrels were sold in year five, average daily production would exceed the depletable oil quantity in year five if reference were only made to income. See n.4, *supra*.

Arguably, income would be required to be backed up by extraction, but whether "production" is exempt would be determined by reference to the year of extraction and income would only determine the timing of the percentage depletion deduction. If 300,000 barrels were extracted each year for four years, all 1,200,000 barrels would be exempt "production" since the depletable oil quantity measured by extraction was never exceeded in any year. The entire year five income would be subject to a full allowance without reference to sec. 613A(c)(7)(A). Such an analysis would require a detailed and perhaps impossible tracing of extraction necessary to determine what extraction was being sold.

	1975	*1976*
Extraction in Barrels	2,000	5,000
Income in Barrels	3,000	4,000

Under the regulations approach (and, perhaps, the majority's), *C* would have 2,000 barrels of "production" in 1975 because, while 3,000 barrels gave rise to income, only 2,000 of those barrels were backed by extraction. In 1976, *C* would have 4,000 barrels of "production" because, while 5,000 barrels were extracted only 4,000 barrels gave rise to income. Even though *C* did not exceed his depletable oil quantity in either year, he is deprived of percentage depletion with respect to the 1,000 barrels which gave rise to income in 1975 but were extracted in 1976. Respondent gets the best of both worlds, and a harsh result obtains. Since respondent recognizes that "production" cannot mean just extraction *this* year but must necessarily somehow relate to gross income, I am at a loss to understand his rationale for distinguishing between income received before extraction and income received after or with extraction. In other words, if "production" is based on income when extraction has occurred in the past, it is capricious to say that "production" is not based on income solely because extraction will occur only in the future.[7]

Furthermore, not only does requiring income to be backed by extraction deny percentage depletion with respect to *any* oil paid for before it is extracted, respondent's interpretation creates additional accounting requirements. Extraction not matched by current sales must be noted and carried forward until the income therefrom is recognized for tax purposes. There is absolutely no statutory authority for such a requirement, which causes "production" to take on an excessively complicated and burdensome meaning. Therefore, I would reject respondent's income-backed-by-extraction interpretation of "production."[8]

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[7] In essence, respondent in using sec. 613A(c) to revert to his position which the United States Supreme Court rejected in *Herring* v. *Commissioner*, 293 U.S. 322 (1934).

[8] Respondent's interpretation is found in proposed regulations which "carry no more weight than a position advanced on brief by the respondent." *F.W. Woolworth Co.* v. *Commissioner*, 54 T.C. 1233,

There is a third possible meaning which the majority might be attaching to "production," that is that "production" means a combination of extraction and income regardless of which occurs first. Under this approach, both elements are required with "production" for section 613A(c) purposes occurring when the later of extraction or income occurs.

Assume the following facts: In 1975, *D*, a calendar year, cash basis taxpayer extracts 1,000 barrels and receives income for 5,000 barrels. In 1976, *D* extracts 2,000 barrels and receives income for 1,000 barrels. In 1977, *D* extracts 5,000 barrels and receives income for 1,000 barrels. Those facts are charted below:

	1975	*1976*	*1977*
Extraction in Barrels	1,000	2,000	5,000
Income in Barrels	5,000	1,000	1,000

Under this third approach, which may or may not be that of the majority, *D* would have 1,000 barrels of "production" in 1975 since the required element of extraction had only occurred with respect to 1,000 barrels. In 1976, *D* would have 2,000 barrels of "production" because 2,000 more barrels had been both extracted and paid for by 1976. In 1977, *D* would have 4,000 barrels of "production" because, while 5,000 barrels were extracted, only 4,000 barrels worth of unaccounted for income would have been received. Thus, 1,000 barrels of extraction would be carried forward until it could be matched with its income.

While the above interpretation might achieve some interplay between sections 613A(c) and 613(a) without wholesale denial of percentage depletion with respect to advance payments, it would effectively rewrite section 613(a). As I have previously noted, section 613(a) grants a deduction based on a percentage of "gross income." Section 1.613-3(a), Income Tax Regs., defines "gross income" as "the amount for which the taxpayer sells the oil or gas." Thus, section 613(a) always has been applied as granting a

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1265-1266 (1970). The Court was not presented with final regulations which "must be sustained unless unreasonable and plainly inconsistent with the statute." See *Bingler* v. *Johnson*, 394 U.S. 741, 750 (1969).

deduction in the same year as the taxpayer recognizes the gross income under his method of accounting. See *Herring* v. *Commissioner*, 293 U.S. 322 (1934). See, e.g., *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969). See also sec. 1.611-2(a)(2), Income Tax Regs. There is no support for interpreting section 613(a) differently when section 613A(c) is involved than when section 613A(c) is not involved. Section 613A(c) does not rewrite section 613(a). In fact, section 613A(c)(1) directs computation "in accordance with section 613."

If, for section 613A(c) purposes, a percentage depletion deduction could be taken only when the later of extraction or income occurred, not only would long established interpretations of section 613(a) be overruled, but a serious mismatching of income and deductions would obtain. For example, if our taxpayer, *D*, had income from 1,200,000 barrels in year one prior to any extraction, he would have a large amount of income in that year but no percentage depletion deduction. If, in years two through five, *D* actually extracted 300,000 barrels each year he would be entitled to a deduction based on the prior income from those barrels even though he had no gross income in the years of extraction.[9] I cannot help but wonder whether such a result would represent a failure clearly to reflect income under section 446(b).[10] For the above reasons, I would reject any later-of-income-or-extraction interpretation of "production."

In summary, whatever interpretation the majority opinion is silently giving "production" in order to deny percentage depletion with respect to advance payments, I believe

[9] Presumably, even though D received income with respect to all 1,200,000 barrels of his oil in one year he would get a percentage deduction with respect to all of it since he spread out extraction. See n.6, *supra*.

[10] Furthermore, if income were recognized in one year and percentage depletion deductions calculated on that income were taken in other years, the amount of deduction limits based on taxable income found in secs. 613(a) and 613A(d)(1) would be nonsensical. See also sec. 613A(c)(7)(C).

its position is unsupportable.[11] I see only one possible interpretation of "production."

In my view "production" means the extraction (past, current, or future) properly attributable to a taxpayer's taxable year as measured by the income received in that year. In other words, the number of barrels giving rise to income in a year is the number of barrels of "production" that year. Thus, if a taxpayer had the following extraction and barrels giving rise to income:

	1975	*1976*	*1977*
Extraction in Barrels	0	2,000	6,000
Income in Barrels	5,000	1,000	1,000

His "production" under sections 613A(c) would be 5,000 barrels in 1975, 1,000 barrels in 1976, and 1,000 barrels in 1977 since those are the number of barrels represented by income in each of those years.

Placing extraction in a year by reference to income interprets the term "production" without reading a myriad of calculations and carryovers into the statute. Not only is it a straightforward interpretation, it comports with the basic rule of natural resources taxation that depletion is

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[11] The majority opinion repeatedly notes that there has been no extraction under the oil and gas leases herein. The question which immediately leaps to mind is what if one barrel of oil had been extracted? Respondent's reply is clear—no percentage depletion deduction because that barrel of oil cannot be specifically traced to any of the advance royalties. See sec. 1.613A-7(f), Proposed Income Tax Regs., 42 Fed. Reg. 24287 (May 13, 1977); Rev. Rul. 81-44, 1981 I.R.B. 6. The majority opinion may well be adopting respondent's position; I cannot tell. On the other hand the majority opinion may contemplate allowing a percentage depletion deduction calculated on the part of the advance payment which they feel is attributable to the extraction. How it would achieve such attribution without ultimately allowing all income received to represent barrels is beyond me.

Moreover, if advance royalties are recoupable against earned royalties, respondent will allow percentage depletion with respect to the part of the advance payment which can be tied to recoupment to extraction in the year the advance payment is received. Nevertheless, that portion of the advance payment recouped through later years' extraction would not be subject to percentage depletion. See sec. 1.613A-3(a)(4), example (4), Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 13, 1977).

calculated on income rather than on the physical withdrawal of the mineral from its resting place. See sec. 1.611-2(a)(2), Income Tax Regs. See generally *Shamrock Oil & Gas Corporation*, 35 T.C. 979 (1961), affd. 346 F.2d 377 (5th Cir.), cert. denied 382 U.S. 892 (1965).

Furthermore, my interpretation fulfills what I perceive to be the intent of Congress. While section 613A(c)'s legislative history is limited, see majority, *supra* at n.20, the one salient fact that emerges from a perusal of the floor debates is that Congress intended to preserve the percentage depletion deduction for certain taxpayers, small independent producers and royalty owners, while severely curtailing its benefits to major oil producers.[12] Most importantly, there is no evidence of any intent to alter the manner in which percentage depletion is calculated or to overrule prior law concerning advance payments.[13]

Under pre-section 613A law, the treatment of advance royalties was clear. When the lessor-royalty owner took the advance payment into income, it was gross income from the property and subject to percentage depletion regardless of whether or not any oil and gas extraction had taken place. *Anderson* v. *Helvering*, 310 U.S. 404, 409 (1940); *Herring* v. *Commissioner*, 293 U.S. 322 (1934). As far as a lessor

[12] If a taxpayer's average daily production exceeds his depletable oil quantity, he is still entitled to percentage depletion, but its benefits are greatly reduced. See sec. 613A(c)(7)(A).

[13] Conf. Rept. No. 94-120, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 624, 629-630, states that:

> [T]he Senate amendment *retains* percentage depletion at 22 percent on a permanent basis for the small independent producer * * *. [Emphasis added.]

The above-quoted language indicates retention rather than abrogation of basic percentage depletion rules. However, the majority opinion disclaims that language by characterizing it as explaining an unenacted "Senate version of the bill." Majority, *supra* at 19. In fact, the legislative history reveals that the enacted Conference substitute "follows the Senate amendment in providing a small producer *exemption from the repeal of percentage depletion* for oil and gas." Conf. Rept. No. 94-120, *supra* at 630. [Emphasis added.] The enacted bill was, in effect, the Senate version—the only differences being phase downs of percentages and barrel amounts and elimination of a plowback requirement.

royalty owner is concerned, advance royalties are received with respect to extraction that will occur in the future rather than occurring now or in the past.[14] To restrict "production" in section 613A(c) to current or past extraction while excluding future extraction "in effect overrules prior case law without a clear statutory mandate." See Linden, *Oil and Gas Depletion Regulations: Complexity Compounded*, 24 Oil & Gas Tax Q. 351, 380 (1976). See also Bravenec, *Continued Availability of Percentage Depletion On Oil and Gas*, 23 Oil & Gas Tax Q. 204 (1975). On the other hand, interpreting "production" as extraction attributable to a year by reference to income allows almost fifty years of clear law to stand.

The majority opinion states that considering future extraction "would mean that 'production' as used in section 613A(c) should be read to mean 'sales of future production.'" Majority opinion, *supra* at 23. I strongly disagree. I am not maintaining that Congress accidentally wrote "production" rather than "sales." I do maintain that Congress intended "production during the taxable year" to include all extraction properly attributable to that year whether it be past, current, or future extraction. Even respondent recognizes that "production" must be interpreted with reference to income.

Furthermore, it is a simple matter to measure "production" in terms of income. "Production" is the number of barrels paid for whether or not the extraction of those barrels has actually occurred. Given the fluctuating prices of oil and gas, Congress drafted the section 613A(c) limitations or percentage depletion couched in terms of "production"

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[14] The treatment of the lessee-payor with respect to depletion and advance payments need not be consistent with the treatment of the lessor-payee. See discussion in *Shamrock Oil & Gas Corporation* v. *Commissioner*, 35 T.C. 979 (1961), affd. 346 F.2d 377 (5th Cir. 1965), cert. denied 382 U.S. 892 (1965). See also Price and Cassell, *Revenue Ruling 79-23 Ignores Tax Reduction Act of 1975*, 28 Oil & Gas Tax Q. 76 (1979). Nevertheless, it seems that the proposed regulations' denial of percentage depletion on advance payments is inconsistent with the "bonus exhaustion" rule of sec. 1.613-2(c)(5)(ii), Income Tax Regs., which is applicable to lessees. See Bravenec & Flagg, *Initial Proposed Section 613A Regulations*, 24 Oil & Gas Tax Q. 218, 224 (1975).

rather than some yearly income amount to avoid the need for constant amendments. However, by referring to section 613(a), Congress made it clear that "production" is inexorably tied to income. Respondent recognizes the tie between income and "production" when the receipt of income is accompanied by current or past extraction, but refuses to acknowledge that tie when income is received prior to extraction.[15] I simply do not see how he can justify such a distinction.

Based on the foregoing, I would hold that petitioners are entitled to a percentage depletion deduction calculated on the full $7,600 in advance royalties received by them in 1975. Those advance royalties were paid with respect to oil and gas extraction, albeit future extraction. See *Anderson* v. *Helvering*, *supra*. Since the taxable year involved herein is 1975, petitioners' "depletable oil quantity" was 2,000 barrels. See sec. 613A(c)(3). Thus, petitioners were allowed 720,000 barrels of "production" in 1975 before their "average daily production" would exceed their "depletable oil quantity."[16] By no stretch of the imagination would $7,600

[15] The majority attempts to disclaim any income based interpretation of "production" as creating "numerous practical problems," majority, *supra* at 24, due to differences between depletable oil quantities and depletable natural gas quantities. A careful reading of sec. 613A(c) belies such worries. Section 613A(c)(3) sets a depletable oil quantity (e.g. 2,000 barrels) while sec. 613A(c)(4) in effect converts gas to barrels (6,000 cubic feet per barrel) which uses up part of the depletable oil quantity. Secondary or tertiary production also reduces the depletable oil quantity. In reality, an *overall* limit of barrels (e.g. 2,000) is being imposed regardless of whether the barrels are oil or gas. The statute merely ensures that a taxpayer does not get a full barrel allowance of *each*.

The only arguable problem is that secondary or tertiary barrels are depleted at 22 percent until 1983 while other barrels fall to 18 percent by 1983. See secs. 613A(c)(6)(A)(ii) and 613A(c)(5). I do not envisage the problem being insurmountable by the burden of proof. At the time of payment, it will probably be known whether secondary or tertiary "production" is involved. The same is true concerning gas "produced from geopressured brine." Sec. 613A(b)(3)(C). Additionally, I note that current sec. 613A(b)(2) was nonexistent in 1975 and should not be considered in a case concerning petitioners' 1975 taxable year.

[16] As shown on their Federal income tax return for 1975, petitioners were calendar year taxpayers in 1975. Calendar year 1975 was made

represent anything near 720,000 barrels in 1975. Accordingly, I would allow petitioners their claimed percentage depletion deduction.[17]

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up of 365 days. Thus, if 720,000 barrels were petitioners' "aggregate production" in 1975, their "average daily production" would be 2,000 barrels/day. See sec. 613A(c)(2)(A).

[17] Of course, if there is never any extraction under the leases involved in this case, petitioners would be required to recapture the percentage depletion deduction. See sec. 1.612-3(b)(2), Income Tax Regs. See also majority, *supra* at n.24.

APPENDIX D

76 T.C. 949

JAMES DAVID GLASS AND WILLIE GLASS, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5169-79.
Filed June 8, 1981.

In 1975, petitioners received bonuses in the total amount of $139,940 upon the execution of several oil and gas leases. Producing oil or gas wells were completed during 1975 on all except one of the properties covered by the leases. The bonus received with respect to the lease on which no well was completed was $19,200. In addition to the bonuses, petitioners received royalties of $24,811 from the producing leases. *Held,* petitioners are not entitled to percentage depletion under sec. 613A(c), I.R.C. 1954, with respect to the lease bonuses.

Guilford L. Jones III, for the petitioners.
John W. Dierker and *Thomas G. Potts,* for the respondent.

OPINION

FEATHERSTON, *Judge:* Respondent determined a deficiency in the amount of $15,472.20 in petitioners' Federal income tax for 1975. The only issue for decision is whether petitioners are entitled to deduct percentage depletion under sections 611[1] and 613A with respect to certain oil and gas lease bonus payments which they received in 1975.

All of the facts have been stipulated.

Petitioners, who are husband and wife, filed a joint Federal income tax return for 1975 with the Internal Revenue Service Center, Austin, Tex. At the time the petition herein was filed, they were legal residents of Sterling City, Tex.

During 1975, petitioners executed certain oil and gas leases covering mineral interests in properties owned by one or both of

[1] All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

them in fee simple. Upon the execution of each lease, petitioners received a bonus as consideration primarily for the right to explore for oil and gas on the leased properties and the right to produce, market, and retain the profits from such oil and gas, subject to the payment of a royalty to petitioners. The bonuses were received without reference to the actual production of oil or gas, and any royalties that might later accrue to petitioners could not be reduced because the bonuses had been received.

There was no production of oil or gas during 1975 from one of the properties covered by a lease executed in consideration of a bonus of $19,200. On the other properties covered by the leases, one or more wells were drilled and completed as producing oil or gas wells during 1975. With respect to these properties, petitioners received bonuses in the total amount of $120,740. They also received $24,811 in royalties on the production from these properties in 1975.

On their 1975 Federal income tax return, petitioners claimed deductions for percentage depletion with respect to the royalties they received on the production of oil and gas during that year and with respect to the bonuses they received upon the execution of the leases from which production was obtained. No deduction for depletion was claimed with respect to the bonus they received for the lease from which there was no production of oil or gas during 1975. In their petition, however, petitioners claimed an overpayment of taxes in the amount of $2,407 on the ground that they are entitled to a percentage depletion deduction in connection with the bonus received for the nonproducing lease.[2]

In the statutory notice of deficiency, respondent allowed the deduction claimed by petitioners for percentage depletion with

[2] This Court has jurisdiction under sec. 6512(b) to determine any overpayment that might have resulted from petitioners' failure to claim a depletion deduction on their 1975 income tax return with respect to the bonus received for the nonproducing lease. The same taxable year as the one covered by the notice of deficiency is involved (sec. 6512(b)(1)), and a timely refund claim could have been filed at the time the notice of deficiency was mailed. See sec. 6512(b)(2)(B).

respect to the royalties received in 1975, but he disallowed in full the deduction claimed by them for percentage depletion on the lease bonuses.

Section 611(a) provides in part that

> "In case of • • • oil and gas wells, [and] other natural deposits, • • • there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion."

In computing the deduction, a taxpayer may be entitled to use either of two different methods prescribed in the Internal Revenue Code — cost depletion[3] or percentage depletion.[4] Where the taxpayer is entitled to use either method, the method allowing the greater deduction for any given tax year must be used to compute depletion for that year. Secs. 1.611-1(a), and 1.613-1, Income Tax Regs.

Prior to 1975, it was well-established law that the recipient of a lease bonus under an oil and gas lease could compute depletion on the basis of either the cost or the percentage method. See, e.g., *Herring* v. *Commissioner,* 293 U.S. 322 (1934). Effective for taxable years beginning after December 31, 1974, however, sections 613(d)[5] and 613A (added by the Tax Reduction Act of 1975, Pub. L. 94-12, 89 Stat. 26 (Mar. 29, 1975)) deny the use of percentage depletion in the case of oil and gas wells, with certain limited exceptions.[6] In this respect, section 613A(a) provides as follows:

SEC. 613A. LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS.

(a) General Rule. — Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613 [i.e., without regard to percentage depletion.]

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[3] See sec. 612; sec. 1.611-2(a), Income Tax Regs.

[4] See secs. 613 and 613A.

[5] Sec. 613(d) provides as follows:

(d) Denial of Percentage Depletion in Case of Oil and Gas Wells. — Except as provided in Section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section.

[6] See sec. 613A(b) and (c).

In contending that all of the oil and gas lease bonuses they received in 1975 are eligible for percentage depletion, petitioners appear to rely primarily upon section 613A(c), which sets forth a carefully circumscribed exception to the general rule of section 613A(a) for independent producers and royalty owners.[7] Emphasizing the express language of section 613A(c), allowing percentage depletion only with respect to a limited quantity of a taxpayer's "average daily production" of oil or gas, respondent maintains that percentage depletion is not allowable on a lease bonus because it is not received with respect to the actual production of oil or gas. On that ground, respondent asks us to hold that petitioners are not entitled to percentage depletion on any of the bonuses received in 1975.

Consistent with our conclusion in *Engle* v. *Commissioner,* 76 T.C. 915 (1981), dealing with advance royalties, we hold that petitioners are not entitled to deduct percentage depletion with respect to their lease bonuses. Section 613A(c) allows percentage depletion deductions only for payments received with respect to actual oil or gas production. Because petitioners' lease bonuses were not received with respect to actual production during the taxable year, they do not qualify for percentage depletion. Under current law, lease bonuses are eligible only for cost depletion.[8]

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[7] The class of persons eligible for the exemption for "independent producers and royalty owners" generally includes taxpayers who are neither "retailers" nor "refiners" within the meaning of sec. 613A(d). There is no question that petitioners fall within the class of taxpayers that qualify for the exemption; rather, the question is whether the bonuses received by petitioners fal' within the exemption.

[8] This conclusion is consistent with the views of text writers. See F. Burke & R. Bowhay, Income Taxation of Natural Resources, sec. 8.32 (1980), which states: "since the percentage depletion allowed by the independent producer and royalty owner exemption requires actual production during the taxable year, * * * lease bonuses no longer qualify for percentage depletion in the year of receipt. [Fn. ref. omitted.]"

Miller's Oil & Gas Federal Income Taxation, sec. 31-3, p. 580 (J. Houghton ed. 1980), states: "Since percentage depletion is allowed only with respect to production [under sec. 613A(c)], no percentage depletion is allowable with respect to lease bonuses."

Section 613A(c)[9] provides, in part, that an allowance for percentage depletion under sections 611 and 613 shall be computed "with respect to • • • so much of the taxpayer's average

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[9] Sec. 613A(c) provides in part as follows:

(c) EXEMPTION FOR INDEPENDENT PRODUCERS AND ROYALTY OWNERS.—

(1) IN GENERAL.—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) AVERAGE DAILY PRODUCTION.—For purposes of paragraph (1)—

(A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.

In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary or his delegate).

(3) DEPLETABLE OIL QUANTITY.—

(A) IN GENERAL.—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) PHASE-OUT TABLE.—For purposes of subparagraph (A)—

In the case of production during the calendar year:	The tentative quantity in barrels is:
1975	2,000
1976	1,800

daily production of domestic crude oil [and natural gas] as does not exceed the taxpayer's depletable oil [and natural gas] quantity." The taxpayer's "average daily production" of oil or gas is to be determined by dividing his aggregate production of oil or gas "during the taxable year" by the number of days in the taxable year. The depletable oil quantity—which the average daily production subject to percentage depletion may not exceed — is computed by reference to a prescribed number of "barrels" of production during the calendar year" reduced by the taxpayer's average daily secondary or tertiary production "for the taxable year."[10] The depletable natural gas quantity is

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1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(4) DAILY DEPLETABLE NATURAL GAS QUANTITY.—For purposes of paragraph (1), the depletable natural gas quantity of any taxpayer for any taxable year shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have this paragraph apply. The taxpayer's depletable oil quantity for any calendar year shall be reduced by the number of barrels with respect to which an election under this paragraph applies. Such election shall be made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

(5) APPLICABLE PERCENTAGE.—For purposes of paragraph (1)—

In the case of production during the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

[10] Under sec. 613A(c)(2), a taxpayer's average daily production is determined with reference to his aggregate production during the "taxable year." However, the phase-out table in sec. 613A(c)(3) prescribing the tentative

defined to equal 6,000 "cubic feet"[11] of gas multiplied by the number of barrels of the taxpayer's depletable oil quantity that he elects to take into account for this purpose.

In attempting to apply section 613(A)(c) in accordance with the congressional intent underlying its enactment, we are not aided by any helpful legislative history. As indicated above, the section was added to the Internal Revenue Code by the Tax Reduction Act of 1975. As originally introduced, the bill leading to the act did not affect the percentage depletion allowance. A floor amendment was made in the House of Representatives that would have generally repealed the percentage depletion provisions for oil and gas. 121 Cong. Rec. 4651-4652 (1975). When the bill reached the Senate floor, the Senate added an amendment to provide a limited exemption from the repeal for independent producers and royalty owners. 121 Cong. Rec. 7813 (1975). The Senate amendment, altered to provide an even more limited exemption, became section 613A(c). The Conference Report provides no guidance for the application of the statutory language in the circumstances here presented. See Conf. Rept. 94-120, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 624, 629-630.

We are thus left only with the language employed by Congress in the Tax Reduction Act of 1975 as a guide to the congressional purpose in enacting the provisions concerning

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number of barrels in the taxpayer's depletable oil quantity, as well as the table in sec. 613A(c)(5) specifying the percentage to be used in computing percentage depletion, is keyed to the "calendar year." Thus, if a taxpayer is on a fiscal year, "each portion of such taxable year which occurs during a single calendar year shall be treated as if it were a short taxable year." Sec. 613A(c)(10).

Separate provisions are made for the allowance of percentage depletion on secondary or tertiary production of domestic crude oil and natural gas. See sec. 613A(c)(6).

[11] In H. Williams & C. Meyers, Manual of Oil and Gas Terms 565 (1976), the term "cubic feet is defined as follows:

> "The volume of gas contained in one cubic foot of space at a standard pressure base of 14.65 pounds per square inch absolute and at a standard temperature base of 60 degrees Fahrenheit. Whenever the conditions of pressure and temperature differ from the above standard, conversion of the volume from these conditions to the standard conditions is made in accordance with the Ideal Gas Laws, corrected for deviation."

percentage depletion for oil and gas. The words by which "the legislature undertook to give expression to its wishes" are, however, usually the most "persuasive evidence" of the purpose and meaning of a statute. *United States* v. *Amer. Trucking Ass'ns.*, 310 U.S. 534, 543 (1940); *Gutierrez* v. *Commissioner*, 53 T.C. 394, 400 (1969), aff'd. per order (D.C. Cir., Dec. 9, 1971). Unless the language of the statute is plainly at variance with some clearly defined legislative policy, we cannot look beyond the normal meaning of the words chosen by Congress. *Busse* v. *Commissioner*, 479 F.2d 1147, 1151-1153 (7th Cir. 1973), affg. 58 T.C. 389 (1972). We must examine petitioners' arguments in the light of these principles.

As we read section 613A(c), it does not permit percentage depletion with respect to an oil and gas lease bonus, and we find no legislative policy supporting petitioners' claims. Percentage depletion is allowable, in the words of the section, with respect to "so much of the taxpayer's average daily production" as does not exceed a specified depletable quantity. Under section 613A(c)(3), oil production is measured in "barrels," defined to mean "42 United States gallons" (sec. 613A(e)(4)), and under section 613A(c)(4), natural gas production is measured in terms of "cubic feet." In the oil and gas industry, "The word 'production' means marketable oil or gas." *Rogers* v. *Osborn*, 152 Tex. 540, 261 S.W.2d 311, 312 (1953). See, e.g., *Garcia* v. *King*, 139 Tex. 578, 164 S.W.2d 509 (1942); *Monsanto Co.* v. *Tyrrell*, 537 S.W.2d 135, 137 (Tex. Ct. App. 1976) ("production" has "a definite legal meaning, namely, the actual physical severance of the mineral from the soil"). See generally H. Williams & C. Meyers, Manual of Oil and Gas Terms 454-455 (1976). Thus, we think it clear that the section 613A(c) exception to the general denial of percentage depletion in the case of oil and gas wells applies only with respect to the actual production of oil or gas.

Lease bonuses, such as those received by petitioners, are not paid "with respect to" the production of oil or gas as that term is used in section 613A(c).[12] As explained in Miller's Oil & Gas Federal Income Taxation, sec. 18–1, p.290 (1980):

"Bonus" is the term applied to money received by the lessor upon execution of an oil and gas lease. As a practical matter, insofar as the lessee is concerned, the bonus pays for the right to enter upon the leased premises and explore for oil and gas commonly for a year from the date of the lease. [Fn. ref. omitted.]

In *Burnet* v. *Harmel*, 287 U.S. 103 (1932), the Supreme Court, holding that lease bonuses were not consideration for the sale of oil and gas in place (i.e., were not capital gain) but were ordinary income, stated (p. 111):

[Bonus] payments made by the lessee are consideration for the right which he acquires to enter upon and use the land for the purpose of exploiting it, as well as for the ownership of the oil and gas; • • • the bonus payments are paid and retained, regardless of whether oil or gas is found and despite the fact that all which is not abstracted will remain the property of the lessor upon termination of the lease.

Here, petitioners received royalties on production in 1975 from all except one of their leases,[13] and they have been allowed percentage depletion deductions with respect to those royalties. However, the lease bonuses here in issue were not received "with respect to" petitioner's "average daily production" of oil

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[12] In fact, the parties have stipulated that the "bonuses were paid without respect to production."

[13] Although sec. 613A(c)(1) refers to "so much of the taxpayer's average daily production," without reference to a taxpayer's separate properties, other provisions in sec. 613A(c) refer to individual properties of the taxpayer: "any property" (sec. 613A(c)(2)(B)), "each property" (sec. 613A(c)(7)(A) and (B)), "the property" (sec. 613A(c)(7)(C)), "each partnership oil or gas property" (sec. 613A(c)(7)(D)). Sec. 614(a) states that the term "property" means "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." We think, therefore, that petitioners' rights to percentage depletion must be tested with respect to each lease. See *Snead* v. *Commissioner*, 119 F.2d 767, 769 (5th Cir. 1941), affg. 40 B.T.A. 1136 (1939). For convenience, however, we have not separately discussed their rights with respect to each lease bonus.

or gas "during the taxable year," and section 613A(c) does not, therefore, allow percentage depletion with respect to them.

It is true, as previously noted, that prior law permitted percentage depletion deductions with respect to oil and gas lease bonuses. But the statute as it then stood (section 613 and its predecessors) made "gross income from the property," without qualification, the base for computing percentage depletion. There was no requirement that the gross income be received with respect to the actual production of oil or gas. The theory underlying the allowance of depletion (whether cost or percentage) on a lease bonus under prior law was that, in a leasing arrangement (as distinguished from a sale or exchange), the initial cash payment is in reality an advance royalty payment in the hands of the lessor which diminishes the value of the lessor's mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income was designed to compensate him for the diminution in value of his interest thereby sustained. See *Palmer* v. *Bender,* 287 U.S. 551 (1933); *Murphy Oil Co.* v. *Burnet,* 287 U.S. 299 (1932); *Burnet* v. *Harmel,* 287 U.S. 103 (1932). Consequently, if the lessor retained the right to share in the oil or gas if and when produced, the bonus was said to be "payment in advance for oil and gas to be extracted." *Herring* v. *Commissioner,* 293 U.S. 322, 324 (1934).

Although this same rationale continues to support the deduction of cost depletion with respect to lease bonuses,[14] section 613A(c) does not permit the deduction of *percentage* depletion with respect to payments in advance for future production, anticipated production, or oil and gas which may or may not be extracted at some time in the future. That section refers to "production," "aggregate production," and "average daily production" of "domestic crude oil" and "domestic natural gas," "during" the taxpayer's "taxable year" and prescribes computations to be made in the light of "production during the calendar

[14] Petitioners do not claim cost depletion with respect to the bonuses received on the execution of any of the leases here in issue.

year." The terms "crude oil" and "natural gas" are specifically defined in the section and the word "domestic" as it modifies those terms "refers to production from an oil or gas well located in the United States or in a possession of the United States."[15] The language of the section is so clear that it allows no leeway to "impute production," as petitioners would have us do, to their bonuses so that they can qualify for percentage depletion deductions with respect thereto. Furthermore, the fact that production from some leases was obtained in the same taxable year as the bonuses were received did not convert the lease bonuses—which were received as consideration for the execution of the leases, which were to be retained regardless of whether oil or gas was found, and which did not affect subsequent royalties—into gross income from the actual production of oil or gas.[16]

Practical problems, moreover, would arise in the application of section 613A(c) if it were interpreted generally to permit the allowance of percentage depletion with respect to lease bonuses. At the time a lease is executed or is assigned, the lessor may not

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[15] Sec. 613A(e) provides as follows:

(e) DEFINITIONS.—For purposes of this section —

(1) CRUDE OIL.—The term "crude oil" includes a natural gas liquid recovered from a gas well in lease separators or field facilities.

(2) NATURAL GAS.—The term "natural gas" means any product (other than crude oil) of an oil or gas well if a deduction for depletion is allowable under section 611 with respect to such product.

(3) DOMESTIC.—The term "domestic" refers to production from an oil or gas well located in the United States or in a possession of the United States.

(4) BARREL.—The term "barrel" means 42 United States gallons.

[16] It may be argued that, if the bonuses were theoretically payments in advance for oil or gas to be produced, a proportionate part thereof may be treated as payment for the production received in 1975 and, thus, subject to percentage depletion. However, petitioners have not shown what part (if any) of the bonuses would be allocable to the production in 1975. In any event, for the reasons stated in the text, we think the language of sec. 613A(c) proscribes such treatment. Assuming that the Congress intended the term "production" in sec. 613A(c) to have the same meaning as it has in the oil and gas industry, we note that it has been held that advance payments for gas to be produced do not constitute payment for production within the meaning of an oil and gas lease. *Monsanto Co.* v. *Tyrrell*, 537 S.W.2d 135, 137 (Tex. Ct. App. 1976).

know what mineral will be discovered or (in some cases) what method of recovery will be required to produce it. The section prescribes different formulae for computing a taxpayer's "depletable oil quantity" (section 613A(c)(3)) and a taxpayer's "depletable natural gas quantity" (sec. 613A(c)(4)). An entirely separate set of rules is prescribed with respect to the allowance of depletion on secondary and tertiary production. Sec. 613A(c)(6). If a taxpayer has "excess" production during the taxable year, he must allocate the taxable income from the property between oil and gas production. Sec. 613A(c)(7). Thus, where there is no production from a lease during the taxable year, there may be no way to determine when the bonus is received whether the section 613A(c) limitations on oil or gas and on primary or (in some situations) secondary or tertiary production would apply.

Petitioners contend, in the alternative, that the section 613A(a) prohibition against the deduction of percentage depletion with respect to any "oil or gas well" does not apply to oil and gas lease bonus payments because such payments were received without reference to the existence of a "well" as such. This argument is without merit. Section 611(a) is the operative section, and it grants the allowance for depletion in the case of "oil and gas wells." Under the law prior to the enactment of the Tax Reduction Act of 1975, lease bonuses were treated as gross income from "oil and gas wells" within the meaning of section 611(a) and its predecessors. See *Herring* v. *Commissioner, supra* at 324-325. Section 613A(a) expressly provides that "the allowance for depletion under section 611" with respect to any "oil or gas well" shall generally be computed without regard to percentage depletion under section 613. Clearly, therefore, oil and gas lease bonuses fall within the general prohibition of this rule.

We conclude that none of petitioners' lease bonuses qualify for the percentage depletion deduction. We understand section 613A(c) to be a limited exception to the repeal of percentage depletion in the case of oil and gas wells. It is cast in terms of the actual production of barrels of crude oil and cubic feet of natural gas. Given the language of the statute and the absence

of any legislative history indicating that the language does not mean what it says, percentage depletion is not allowable on lease bonuses. We can find nothing in the statute or legislative history to authorize the conversion of bonus dollars into barrels of oil or cubic feet of gas for percentage depletion purposes.

To reflect the foregoing,

Decision will be entered for the respondent.

Reviewed by the Court.

NIMS, *J.*, did not participate in the consideration or disposition of this case.

GOFFE, *J.*, concurring: for the reasons set forth in my concurring opinion in *Engle* v. *Commissioner*, 76 T.C. 915, 927 (1981), I concur in the holding and rationale of the majority opinion. However, I again feel a need to briefly address some of the statements made in the dissenting opinion.

The dissent perceives in the majority opinion an implication that percentage depletion would not be allowed with respect to both past and future production. I, of course, agree that future possible production cannot support a present percentage depletion deduction. Because there was no actual past production in the case before us, the majority was not compelled to, and did not, make a holding concerning the legal effect of such a situation. The majority opinion, read as a whole, certainly supports the conclusion I have reached that both past and present actual production will support a present-year percentage depletion deduction. I have elaborated this theory at length elsewhere[17] so I will not dwell on it here.

The dissent is troubled by the perceived implication of the majority opinion that lease bonuses are not payments for oil or gas, and that such an implication is contrary to established case law. The majority implies no such thing. No one denies that lease bonuses are payments for oil or gas. However, it is equally undeniable that, as the majority states at page 955 of its opinion, lease bonuses are not paid with respect to production. In

[17] *Engle* v. *Commissioner*, 76 T.C. 915, 928-930 (1981)(Goffe, J., concurring).

fact, bonus payments are paid and retained regardless of whether oil or gas is found or produced. *Burnet* v. *Harmel*, 287 U.S. 103, 111 (1932). Sales of oil and gas necessarily imply production but payments to the owner of a mineral interest for the privilege of exploring for oil or gas do not in any way imply that oil or gas has been produced or that it even exists. Under section 613A, I.R.C. 1954,[18] there no longer exists any percentage depletion without actual production. Since lease bonuses are not paid and received "with respect to" actual, existing production, they are no longer subject to percentage depletion.

Finally, I would reemphasize one of the major practical problems with the dissent's proposed interpretation, i.e., how to convert bonuses into units of production for purposes of determining a taxpayer's average daily production under section 613A(c). What prices would one use to convert a $10,000 (or $100,000) bonus into a number of barrels of oil or into a quantity of cubic feet of gas? The dissent never addresses, let alone answers, this question. The question is not answered under the controlling law, probable because no one foresaw an interpretation such as the dissent's that would require such a conversion. The majority's approach avoids the necessity of asking such unanswerable, and uncontemplated, questions.

FAY, *J.*, dissenting: I respectfully dissent. In my opinion, lease bonuses do in fact represent "production" for purposes of section 613A(c).[19] As most of the reasons for my disagreement with the majority position are set forth at length in my dissenting opinion in *Engle* v. *Commissioner*, 76 T.C. 915, 940 (1981), my comments will be brief.

It seems that the majority opinion denies percentage depletion deductions based on the lease bonuses in this case because

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[18] All section references are to the Internal Revenue Code of 1954 as amended.

[19] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

those lease bonuses were not income directly traceable to extraction occurring in the same taxable year as the lease bonuses were received. In other words, the majority opinion seems to require both extraction and *that* extraction's income to occur in the same taxable year for a percentage depletion deduction to be allowable.[20] Such reasoning would, in effect, dissallow percentage depletion with respect to any oil sold in a taxable year other than the taxable year that oil is actually extracted. As I noted in *Engle* v. *Commissioner, supra* at 941 (Fay, J., dissenting), that is obviously not what Congress intended.[21]

I am also troubled by the implication in the majority opinion that lease bonuses are not payments for oil or gas. It is well settled that lease bonuses are considered payments for oil or gas for depletion purposes. As the United States Supreme Court said in *Anderson* v. *Helvering,* 310 U.S. 404, 409 (1940), "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and given the same tax consequences." See *Herring* v. *Commissioner,* 293 U.S. 322 (1934); *Burnet* v. *Harmel,* 287 U.S. 103, 112 (1932) (bonus and royalties are both consideration for the lease, neither are capital gains); *Palmer* v. *Bender,* 287 U.S. 551, 557-558 (1933) (lessor entitled to depletion on

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[20] However, the majority, *supra* at 957, also seems to say that only future extraction is tainted. That may imply that extraction occurring in a year previous to that extraction's income could serve as a basis for percentage depletion. See sec. 1.613A(c)—3(a)(4), example (*4*), Proposed Regs., 42 Fed. Reg. 24281 (May 13, 1977). See also *Engle* v. *Commissioner,* 76 T.C. 915, 940 (1981) (Fay, J., dissenting).

[21] The majority opinion states that its conclusion "is consistent with the views of text writers" (majority, *supra* at note 8), and cites two authorities. In F. Burke & R. Bowhay, Income Taxation of Natural Resources, sec 8132 (1980), the authors do in fact state that lease bonuses do not qualify for percentage depletion. However, they do not analyze the issue and rely only on the proposed regulations promulgated under sec. 613A(c). Proposed regulations, of course, represent no more than respondent's litigating position. *F. W. Woolworth Co.* v. *Commissioner,* 54 T.C. 1233, 1265-1266 (1970). In Miller's Oil & Gas Federal Income Taxation, sec 31-3, p. 580 (J. Houghton ed. 1980), the authors reach the same conclusion as Burke & Bowhay. But they do point out the incongruity of distinguishing between pre-extraction income and post-extraction income. J. Houghton, *supra* at 580-581. Furthermore, they point out that the proposed regulations have been severely criticized on the very grounds which form the basis for my dissent J. Houghton, *supra* at 581 n. 15.

bonus and royalties). See also *Shamrock Oil & Gas Corp.* v. *Commissioner,* 35 T.C. 979 (1961), affd. 346 F.2d 377 (5th Cir. 1965), cert. denied 382 U.S. 892 (1965).[22]

The majority opinion discounts the above line of authority as, in effect, having been overruled by section 613A. Majority, *supra* at 956. I disagree. In the first place, "gross income from the property" always has been necessarily related to extraction (sec. 1.613–3(a), Income Tax Regs.); and, second, "gross income from the property" is still the percentage depletion calculation base for purposes of applying sec. 613A(c)(1) ("the allowance for depletion • • • shall be computed in accordance with section 613").

I emphasize that I am not maintaining that "production" does not mean extraction. Upon that point, the majority and I agree.[23] I do maintain that "production" is not limited to current extraction but includes past or future extraction as well. In my view, "production during the taxable year" means the extraction (past, current, or future) properly attributable to that year. The number of barrels of extraction properly attributable to a year is easily measured by income. Indeed, such always has been the case under section 613, which explicitly ties percentage

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[22] The majority opinion completely omits any mention of those writers reaching a result opposite its own. See Linden, "Oil and Gas Depletion Regulations: Complexity Compounded," 24 Oil & Gas Tax Q. 351, 380 (1976) (excluding future extraction from "production" for purposes of sec. 613A(c) overrules prior case law without a clear statutory mandate); Bravenec, "Continued Availability of Percentage Depletion on Oil and Gas," 23 Oil & Gas Tax Q. 204, 212 (1975) ("the construction of 'production' as sales for all purposes under Section 613A(c) is highly desirable"). In fact, I have been unable to locate any author to date who has analyzed the issue involved in this case in depth and agrees with the proposed regulations.

[23] I note that in defining "production" to mean extraction, the majority cites Texas cases in which "production" was held to mean current extraction. However, none of those cases dealt with either depletion or Federal taxation. Rather, they were contract cases involving construction of oil and gas leases with the courts' inquiry being what the parties to the various contracts meant by "production." Accordingly, those cases should have no bearing on the interpretation of "production" as that term is used in sec. 613A(c). As the United States Supreme Court said in *Burnet* v. *Harmel,* 287 U.S. 103, 110 (1932), "State law may control only when the operation of the federal taxing act, by express act or necessary implication, makes its own operation dependent on state law."

depletion to income. The logical bases for my position are fully elucidated in my dissenting opinion in *Engle* v. *Commissioner, supra.*[24]

In this case, I would allow petitioners a percentage depletion deduction calculated on all the lease bonuses received by them in 1975. Those bonuses represent extraction, albeit future extraction, for depletion purposes; that extraction is properly attributable to 1975, the taxable year in which the petitioners received income from that extraction; and, as stipulated by the parties, inclusion of the extraction represented by the lease bonuses in petitioners' 1975 "production" would not cause petitioners to exceed their 1975 "depletable oil quantity." Accordingly, I would hold for petitioners.

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[24] Additionally, a number of the points made by the majority opinion in this case have been fully addressed in my dissenting opinion in *Engle* v. *Commissioner,* 76 T.C. 915, 940–948 (1981). The majority's conclusion that there is no helpful legislative history (majority, *supra* at 954) is a vast overstatement. See *Engle* v. *Commissioner, supra* at 946 n. 13 (Fay, J., dissenting). The majority's reliance on the parties' stipulation of no "production" (majority, *supra* at note 12), ignores the obvious meaning of that stipulation. *See Engle* v. *Commissioner, supra* at 940 n. 2 (Fay, J., dissenting). Finally, the practical problems which the majority envisages flowing from my interpretation (majority, *supra* at 958) are addressed in *Engle* v. *Commissioner, supra* at 948 n. 15 (Fay, J., dissenting).

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

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SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to

the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) [As amended by Section 501(b)(2)(A), Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 53.] *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 22 Percent—

(A) sulphur and uranium; and

(B) if from deposits in the United States—anorthosite, clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanitum, tungsten, vanadium, and zinc.

* * * * *

(d) [As amended by Section 501(υ)(1), Tax Reduction Act of 1975, *supra* 89 Stat. 53.] *Denial of Percentage Depletion in Case of Oil and Gas Wells.*—Except as provided in Section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section.

* * * * *

SEC. 613A. [As amended by Section 501(a), Tax Reduction Act of 1975, *supra*, 89 Stat. 74 *et seq.*] LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS.

(a) *General Rule.*—Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613.

(b) *Exemption for Certain Domestic Gas Wells.*—

(1) *In general.*—The allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) regulated natural gas, and

(B) natural gas sold under a fixed contract,

and 22 percent shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

• • •

(3) *Definitions.*—For purposes of this subsection—

(A) *Natural gas sold under a fixed contract.*—The term "natural gas sold under a fixed contract" means domestic natural gas sold by the producer under a contract, in effect on February 1, 1975, and at all times thereafter before such sale, under which the price for such gas cannot be adjusted to reflect to any extent the increase in liabilities of the seller for tax under this chapter by reason of the repeal of percentage depletion for gas. Price increases after February 1, 1975, shall be presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence.

(B) *Regulated natural gas.*—The term "regulated natural gas" means domestic natural gas produced and sold by the producer, before July 1, 1976, subject to the jurisdiction of the Federal Power Commission, the price for which has not been adjusted to reflect to any extent the increase in liability of the seller for tax under this chapter by reason of the repeal of percentage depletion for gas. Price increases after February 1, 1975, shall be presumed to take increases in tax liabilities into account unless the taxpayer demonstrates the contrary by clear and convincing evidence.

• • •

(c) *Exemption for Independent Producers and Royalty Owners.*—

(1) *In general.*—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the taxable contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) *Average daily production.*—For purposes of paragraph (1)—

(A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.

In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary).

(3) *Depletable oil quantity.*—

(A) In general.—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) *Phase-out table.*—For purposes of subparagraph (A)—

In the case of production during the calendar year:	The tentative quantity in barrels is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

* * * * *

Office-Supreme Court, U.S.
FILED
MAR 24 1983
STEVAS,
CLERK

No. 82-774

In the Supreme Court of the United States

OCTOBER TERM, 1982

PHILIP D. FARMAR AND MARIAN J. FARMAR, PETITIONERS

v.

UNITED STATES OF AMERICA

A. A. SUGG AND MARY A. SUGG, PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

JOINT APPENDIX

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Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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PETITION FOR A WRIT OF CERTIORARI FILED NOVEMBER 5, 1982
CERTIORARI GRANTED JANUARY 10, 1983

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RELEVANT DOCKET ENTRIES

Case No. 15-80 T

Date	Proceedings
Jan 9 1980	Filing fee of $10 paid by plaintiffs.
Jan 31 1980	Notice of reference to Trial Judge Mastin G. White filed. Copy to parties.
Mar 10 1980	Defendant's answer to the petition filed. Copies (5) to atty.
Mar 12 1980	Trial Judge's standard pretrial order on liability (Rule 111) filed. Copy to parties. [submission due: May 12 1980].
Apr 14 1980	Plaintiff's motion to extend time (to July 14, 1980) to comply with pretrial order filed. Copies (2) to deft. ALLOWED APR 28 1980.
Aug 7 1980	Plaintiffs' motion for consolidation of cases (this, and 16-80T) file Copies (2) to deft. ALLOWED: AUG 25 1980.
Sep 2 1980	Defendant's motion for extension of time (to Oct. 16, 1980) to comply with pretrial order filed in this, and 16-80. Copies (2) to atty. ALLOWED SEP 22 1980.
Jun 8 1981	Defendant's motion for summary judgment and brief filed. Copies (5) to atty.
Jun 8 1981	Exhibits to stipulation accompanying brief filed. Copy to atty.
Jun 8 1981	Defendant's motion for leave to file reduced number of copies of exhibits to the stipulation filed. Copies (2) to atty. ALLOWED: JUNE
Jun 23 1981	Plaintiffs' motion for extension of time (to August 7, 1981) to file reply to defendant's motion for summary judgment filed. Copies (2) to atty. [filed in this and 16-80T] ALLOWED: JUN 23 1981.
Aug 7 1981	Plaintiffs' cross-motion for summary judgment, and opposition to defendant's motion for summary judgment filed. Copies (5) to deft. [filed in this and 16-80 T]
Sept 8 1981	Defendant's motion for enlargement of time (to Oct 6 1981) to file its reply brief filed. Copies (2) to atty. [filed in this and 16-80 ALLOWED: SEP 11 1981.

Date	Proceedings
Oct 6 1981	Defendant's reply brief in support of its motion for summary judgment and brief in opposition to plaintiffs' cross-motion for summary judgment filed [in this and in 16-80 T]. Copies (5) to atty.
Oct 29 1981	Plaintiffs' motion for extension of time (to December 7, 1981) to file its reply brief filed [in this and 16-80T]. Copies (2) to deft. ALLOWED: OCT 30 1981.
Nov 25 1981	Plaintiffs' reply brief in support of their cross-motion for summary judgment filed [in this and 16-80T]. Copies (5) to deft.
Jan 11 1982	Plaintiffs' motion for leave to file supplemental brief filed (in this and 16-80T). Copies (2) to deft. ALLOWED: JAN 20, 1982, with defendant granted 20 days within which to file a responding supplemental brief.
Jan 19 1982	Defendant's reply to plaintiffs' motion for leave to file supplemental brief filed [in this and 16-80T]. Copies (2) to atty.
Jan 20 1982	Plaintiffs' supplemental brief in support of their cross-motion for summary judgment and in opposition to defendant's motion for summary judgment filed. Copies (5) to deft.
Feb 1 1982	Defendant's response to plaintiffs' supplemental brief filed. Copies (5) to atty.
Apr 7 1982	Argued and submitted on defendant's motion for summary judgment and plaintiff's cross-motion for summary judgment. [Before Davis Cowen and Nichols]. Defendant to furnish copies of referred to U.S. Tax Court decision. [In this and 16-80T]
May 14 1982	Defendant's motion for leave to file an appellate opinion and to submit a supplemental memorandum filed. Copies (2) to atty. [by June 15, 1982] ALLOWED: MAY 17 1982, with plaintiff granted 10 days from receipt of defendant's memo within which to respond
May 17 1982	Opinion of the Court of Appeals in ***Engle v. Commissioner***, filed. Parties notified.
Jun 15 1982	Defendant's supplemental memorandum filed. Copies (5) to atty.

Date	Proceedings
Jun 21 1982	Defendant's motion for leave to file correction to the supplement memorandum filed Jun 15 1982 filed. Copies (2) to atty. [In this and 16-80 T] ALLOWED: Jun 25 1982
Jun 24 1982	Plaintiffs' answer to the supplemental memorandum for deft. filed. Copies (5) to deft.
Jun 25 1982	Defendant's correction to supplemental memorandum filed. Copies (2) to atty.
Jun 28 1982	Plaintiffs' motion for leave to file an answer to defendant's correction of its supplemental memorandum filed. Copies (2) to deft. ALLOWED: JUN 30 1982.
Jun 30 1982	Plaintiffs' answer to defendant's correction of its supplemental memorandum filed. Copies (2) to deft.
Sep 22 1982	In this and 16-80T, petitions dismissed. Opinion by Judge Davis. Copies to parties.

RELEVANT DOCKET ENTRIES

Case No. 16-80 T

Date	Proceedings
Jan 10 1980	Filing fee of $10 paid by plaintiffs.
Jan 31 1980	Notice of reference to Trial Judge Mastin G. White filed. Copy to parties.
Mar 10 1980	Defendant's answer to the petition filed. Copies (5) to atty.
Mar 12 1980	Trial Judge's standard pretrial order on liability (Rule 111) filed. Copy to parties. [submission due: May 12, 1980].
Apr 15 1980	Plaintiff's motion to extend time (to July 14, 1980) to comply with pretrial order filed. Copies (2) to deft. ALLOWED APR 28 1980.
Aug 7 1980	See plaintiff's motion in 15-80 T to consolidate.
Aug 25 1980	SEE 15-80 T FOR FURTHER PROCEEDINGS.

IN THE UNITED STATES COURT OF CLAIMS

No. 15-80 T

PHILIP D. FARMAR AND MARIAN J. FARMAR, PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

No. 16-80 T

A. A. SUGG AND MARY S. SUGG, PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

STIPULATION

It is hereby stipulated by and between the parties hereto, by their respective counsel, for the purpose of these cases only, that the following statements are true and correct and may be accepted as facts, that all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof, and that these exhibits are true and correct copies.

1. Plaintiffs Philip D. Farmar and Marian J. Farmar reside at 1410 Warwick Lane, Newport Beach, California 92660.

2. Plaintiffs A. A. Sugg and Mary S. Sugg reside in San Angelo, Texas, and have a mailing address of Post Office Box 573, San Angelo, Texas 76902.

3. Plaintiffs engage in various activities, including oil or gas leasing and development as mineral owners.

4. Plaintiffs are not excluded refiners nor excluded retailers but are independent producers or royalty owners within the meaning of those terms in Section 613A.

5. Plaintiff A. A. Sugg owns an undivided 50.52-percent interest in a mineral estate of approximately 46,514.65

acres of land located in Irion County, Texas (hereinafter the "Irion Property").

6. By lease dated December 1, 1975, plaintiff A. A. Sugg executed an oil and gas lease for a term of five years, leasing his ownership of 23,500.97 undivided mineral acres under the Irion Property to Allied Chemical Corporation and Florida Gas Exploration Company.

7. Pursuant to the December 1, 1975, lease agreement for the Irion Property, plaintiff A. A. Sugg reserved the right to receive as royalties the following:

> (a) Twenty (20) percent or one-fifth (1/5) of all oil and gas produced and sold from the property, or
>
> (b) Twenty (20) percent or one-fifth (1/5) equal part of the value of all oil and gas produced and saved from the leased premises.

This fractional royalty represents the mineral owner's share of the oil and gas produced from his property.

8. On December 12, 1975, plaintiff A. A. Sugg executed a Deferred Bonus Agreement with Allied Chemical Corporation and Florida Gas Exploration Company for the Irion Property. Pursuant to this agreement, plaintiff A. A. Sugg was entitled to receive a bonus in the amount of $1,057,543.60, computed at the rate of $45 per mineral acre, for the execution and delivery of the December 1, 1975, lease agreement for the Irion Property.

9. The amount of $1,057,543.60, to which plaintiff A. A. Sugg was entitled under the terms of this December 12, 1975, Deferred Bonus Agreement for the Irion Property, was payable in three installments, as follows:

On or before December 25, 1975	$ 1,000.00
Between January 10 and January 20, 1976	528,271.00
Between January 10 and January 20, 1978	528,271.00
	$1,057,543.60

10. The amount of $1,057,543.60, to which plaintiff A. A. Sugg was entitled under the December 12, 1975, Deferred Bonus Agreement, was payable regardless of whether production of oil or gas commenced pursuant to the lease agreement described in paragraphs 7(a) and 7(b) above and does not affect the fractional amounts to which plaintiff

A. A. Sugg is entitled, if any, after execution of the lease agreement.

11. Pursuant to the December 12, 1975, Deferred Bonus Agreement, plaintiff A. A. Sugg received a payment of $528,271.80 in January 1976. This amount was reported as "oil and gas bonus" income in plaintiffs' 1976 joint income tax return. Plaintiffs A. A. Sugg and Mary S. Sugg claimed a 22-percent depletion allowance on $528,271.80, plus other oil and gas bonuses of $86,400.00, in the amount of $135,227.80, on their 1976 joint income tax return.

12. As a result of an Internal Revenue Service examination of plaintiffs A. A. Sugg and Mary S. Sugg's federal income tax return for the calendar year 1976, on February 10, 1978, the Internal Revenue Service assessed a deficiency in federal income taxes against them in the amount of $95,141.60, plus interest in the amount of $5,981.54 for the calendar year 1976.

13. On April 7, 1978, plaintiffs A. A. Sugg and Mary S. Sugg paid the asserted total deficiency of $95,141.60, plus assessed interest of $5,981.54.

14. On October 5, 1978, plaintiffs A. A. Sugg and Mary S. Sugg timely filed Form 1040X, Amended U.S. Individual Income Tax Return, with the District Director of Internal Revenue, Dallas, Texas, claiming a refund of $95,141.60 for the calendar year 1976. This claim for refund states that an adjustment for statutory depletion of Schedule E should be made with respect to the "lease bonus" of $614,671.80 to permit a percentage depletion deduction of 22 percent.

15. On August 22, 1979, the District Director of Internal Revenue, Dallas, Texas, mailed to plaintiffs A. A. Sugg and Mary S. Sugg a denial of their claim for refund for the calendar year 1976 by certified mail, whereupon these plaintiffs filed a petition that is the subject of this suit.

16. Plaintiff Philip D. Farmar and his four children own an undivided 49.48-percent interest in a mineral estate of approximately 46,514.65 acres of land located in Irion County, Texas (hereinafter the "Irion Property").

17. Plaintiff Philip D. Farmar owns approximately 79.63 percent of the 49.48 percent undivided interest in the Irion Property, or 18,326.78 undivided mineral acres.

18. For the year 1976, plaintiff Philip D. Farmar and his four children filed Form 1065, United States Partnership Tax Return, with respect to the income, deductions, and credits associated with their joint ownership interests in the Irion Property.

19. On December 1, 1975, plaintiff Philip D. Farmar executed a lease for a term of five years, leasing his ownership of 18,326.78 undivided mineral acres under the Irion Property to Allied Chemical Corporation and Florida Gas Exploration Company.

20. Pursuant to the December 1, 1975, lease agreement for the Irion Property, plaintiff Philip D. Farmar reserved the right to receive as royalties the following:

> (a) Twenty (20) percent or one-fifth (1/5) of all oil and gas produced and sold from the property, or
>
> (b) Twenty (20) percent or one-fifth (1/5) equal part of the value of all oil and gas produced and saved from the leased premises.

This fractional royalty represents the mineral owner's share of the oil and gas produced on his property.

21. On December 12, 1975, plaintiff Philip D. Farmar executed a Deferred Bonus Agreement with Allied Chemical Corporation and Florida Gas Exploration Company for the Irion Property. Pursuant to this agreement, plaintiff Philip D. Farmar was entitled to receive a portion of $824,703.44, from the total amount of $1,035,615.60 due to the partnership, computed at the rate of $45 per mineral acre, for the execution and delivery of the December 1, 1975, lease agreement for the Irion Property.

22. The amount of $1,035,615.60, to which plaintiff Philip D. Farmar and his four children were entitled under the terms of this December 12, 1975, Deferred Bonus Agreement for the Irion Property, was payable in five installments, as follows:

On or before December 25, 1975	$ 5,000.00
Between January 10 and January 20, 1976	257,653.90
Between January 10 and January 20, 1977	257,653.90
Between January 10 and January 20, 1978	257,653.90
Between January 10 and January 20, 1979	257,653.90
	$1,035,615.60

23. The amount of $1,035,615.60, to which plaintiff Philip D. Farmar and his four children were entitled under the December 12, 1975, Deferred Bonus Agreement, was payable regardless of whether production of oil or gas commenced pursuant to the lease agreement described in paragraphs 20(a) and 20(b) above and does not affect the fractional amounts to which plaintiff is entitled, if any, after execution of the lease agreement.

24. Pursuant to the December 12, 1975, Deferred Bonus Agreement, plaintiff Philip D. Farmar and his four children received a payment of $257,653.90 in January 1976. This amount was reported on an attachment to the Form 1065, United States Partnership Tax Return, for 1976 as "oil and gas bonus" income.

25. Plaintiff Philip D. Farmar's portion of the amount received in January 1976, pursuant to the December 12, 1975, Deferred Bonus Agreement, was $205,180.86. This amount was reported as income in plaintiffs Philip D. Farmar and Marian J. Farmar's 1976 joint income tax return. As described in an attachment to Schedule E, Part III, of plaintiffs Philip D. Farmar and Marian J. Farmar's 1976 return, their share of the partnership income was $268,975.83 (which includes the $205,180.86 amount received under the Deferred Bonus Agreement for the Irion Property), from which was deducted $5,867.64 representing "Tentative Allowable Statutory Depletion—Royalty;" $45,139.79 representing "Tentative Allowable Statutory Depletion—Bonus;" and $925.79 representing "Expenses Incurred Relating to Partnership."

26. The "Tentative Allowance Statutory Depletion—Bonus" of $45,139.79, represents a 22-percent depletion allowance on the income of $205,180.86 received pursuant to the December 12, 1975, Deferred Bonus Agreement for the Irion Property.

27. As a result of an Internal Revenue Service examination of plaintiffs Philip D. Farmar and Marian J. Farmar's federal income tax return for the calendar year 1976, on August 7, 1978, the Internal Revenue Service assessed a deficiency in federal income taxes against them in the

amount of $23,350.62, plus interest in the amount of $1,720.75 for the calendar year 1976.

28. On August 20, 1978, plaintiffs Philip D. Farmar and Marian J. Farmar paid the asserted total deficiency of $23,350.62, plus assessed interest of $1,720.75.

29. On October 8, 1978, plaintiffs Philip D. Farmar and Marian J. Farmar timely filed Form 1040X, Amended U.S. Individual Income Tax Return, with the District Director of Internal Revenue, Dallas, Texas, claiming a refund of $23,350.62 for the calendar year 1976. This claim for refund states that an adjustment for statutory depletion on Schedule E should be made with respect to the "lease bonus" of $45,139.79 to permit a percentage depletion deduction of 22 percent.

30. On August 15, 1979, the District Director of Internal Revenue, Dallas, Texas, mailed to plaintiffs Philip D. Farmar and Marian J. Farmar a denial of their claim for refund for the calendar year 1976 by certified mail, whereupon these plaintiffs filed a petition that is the subject of this suit.

31. During 1976, the first year of the lease, oil and gas was discovered in the following wells on the Irion Property:

a. Union Texas Petroleum Corporation—Skelly-Sugg "45" in Section 45, Blk 1.

b. Union Texas Petroleum Corporation—No. 1 Sugg "3072" in Section 3072, Blk 1.

c. Union Texas Petroleum Corporation—Farmar "56" in Section 56, Blk 1.

d. Union Texas Petroleum Corporation—McAlester-Sugg "70" in Section 70, Blk 1.

e. Union Texas Petroleum Corporation—Farmar "52" in Section 52, Blk 1.

f. Union Texas Petroleum Corporation—Sugg "3" in Section 3, Blk 6.

During the first year of the lease herein, these six wells produced approximately 25,855 barrels of oil and approximately 13,498,000 cubic feet of gas.

32. If the leasees abandon the lease herein, the lessees are not entitled to a return of any sums paid pursuant to the deferred bonus agreements herein.

33. The amounts to which plaintiffs lessors are entitled under the deferred bonus agreements herein are assured payments and are not subject to alteration in the event the lessees extract a better (or lower) grade of oil or gas; or in the event the lessees drill dry holes and, therefore, are unable to extract any oil or gas.

34. Attached hereto as Joint Exhibit A is a true copy of the Oil and Gas Lease effective December 1, 1975, between Philip D. Farmar, Nancy Farmar Warfield, Andrea Farmar Bjeldanes, Peter D. Farmar, and Philip D. Farmar, as Testamentary Trustee under the Will of Sammie June S. Farmar, Deceased, and Andrew A. Sugg, as lessors and Allied Chemical Corporation and Florida Gas Exploration Company, as lessees.

35. Attached hereto as Joint Exhibit B is a true copy of the Deferred Bonus Agreement dated December 12, 1975, between Andrew A. Sugg, as lessor, and Allied Chemical Corporation and Florida Exploration Company, as lessees.

36. Attached hereto as Joint Exhibit C is a true copy of the Deferred Bonus Agreement dated December 12, 1975, between Philip D. Farmar, Nancy Farmar Warfield, Andrea Farmar Bjeldanes, Peter D. Farmar, and Philip D. Farmar, as Testamentary Trustee under the Will of Sammie June S. Farmar, Deceased, as lessors, and Allied Chemical Corporation and Florida Gas Exploration Company, as lessees.

37. Attached hereto as Joint Exhibit D is a true copy of the Form 1040, U.S. Individual Income Tax Return, for calendar year 1976, for A. A. Sugg and Mary S. Sugg.

38. Attached hereto as Joint Exhibit E is a true copy of the Form 1040X, Amended U.S. Individual Income Tax Return for calendar year 1976, for A. A. Sugg and Mary S. Sugg.

39. Attached hereto as Joint Exhibit F is a true copy of the letter from the District Director, Internal Revenue Service, Dallas, Texas, dated August 15, 1979, denying plaintiffs A. A. Sugg and Mary S. Sugg's claim for refund for calendar year 1976.

40. Attached hereto as Joint Exhibit G is a true copy of a 1976 Form 1040, U.S. Individual Income Tax Return, for Philip D. Farmar and Marian J. Farmar.

41. Attached hereto as Joint Exhibit H is a true copy of Form 1040X, Amended U.S. Individual Income Tax Return for calendar year 1976, for Philip D. Farmar and Marian J. Farmar.

42. Attached hereto as Joint Exhibit I is a true copy of a letter from the District Director, Internal Revenue Service, Dallas, Texas, dated August 15, 1979, denying plaintiffs Philip D. Farmar and Marian J. Farmar's claim for refund for calendar year 1976.

43. Attached hereto as Joint Exhibit J is a true copy of Form 1065, United States Partnership Tax Return, for calendar year 1976, for Philip D. Farmar and Nancy F. Warfield et al., Ptr., Philip D. Farmar Agency.

44. Attached hereto as Joint Exhibit K are certified copies of five (5) pages of the production ledger maintained by the office of the Texas Railroad Commission, Austin, Texas, containing 1976 oil and gas production amounts.

/s/ _____
JAMES A. CARTER
Attorney for Plaintiffs

/s/ _____
JOHN F. MURRAY
Acting Assistant Attorney General

/s/ _____
MAXINE C. CHAMPION
Attorneys for Defendant

JOINT EXHIBIT A

OIL AND GAS LEASE

AGREEMENT, made and entered into this 1st day of December, 1975, by and between ANDREW A. SUGG, herein called "Sugg"; and PHILIP D. FARMAR, NANCY FARMAR WARFIELD (formerly called Nancy Farmar), ANDREA FARMAR BJELDANES (formerly Andrea Farmar), PETER D. FARMAR and PHILIP D. FARMAR, as Testamentary Trustee under the Will of Sammie June S. Farmar, Deceased, for the benefit of Steven S. Farmar, herein collectively called "Farmar", with all of the parties just named collectively hereinafter called Lessor, and ALLIED CHEMICAL CORPORATION, whose address is 1300 Wilco Building, Midland, Texas 79701, and FLORIDA GAS EXPLORATION COMPANY, whose address is 2240 The 1100 Milam Building, Houston, Texas 77002, herein collectively called Lessee.

WITNESSETH: That Lessor, for and in consideration of TEN DOLLARS ($10.00), cash in hand paid, and other good and valuable consideration, the receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of Lessee to be paid, kept and performed, has granted, demised, leased and let, and by these presents does grant, lease and let exclusively unto Lessee for the sole and only purpose of prospecting and drilling for and producing and owning oil and gas, laying pipelines, injecting salt water produced from the premises, building tanks, power stations and other structures thereon to produce, save, care for, treat and transport said products of the lease, the following lands in Irion County, Texas, described in Exhibit A attached hereto and incorporated herein and containing 46,514.65 acres, more or less.

Subject to the other provisions herein contained, this lease shall remain in force for a term of five (5) years from this date (hereinafter called primary term) and subject to conditions herein contained, as long thereafter as oil and gas, or either of them is produced in paying quantities from

the lands hereby leased, or as long thereafter as operations are conducted as hereinafter provided.

In consideration of the premises, Lessee covenants and agrees:

1. To deliver to the credit of Lessor as royalty, free of cost, in the pipeline to which Lessee's wells may be connected, an equal twenty percent (20%) of all oil and gas produced and saved from said leased premises or at the option of Lessor, the same equal part of the value of all oil and gas produced and saved from said leased premises; provided, however, that if Lessor fails to take or dispose of Lessor's royalty oil and/or gas, Lessee shall have the right, for the time being and subject to revocation at Lessor's will, to sell Lessor's share of such oil and/or gas to others and Lessor's share shall be twenty percent (20%) of the total amount realized by Lessee from the sale of one hundred percent (100%) of the oil and/or gas sold from the premises.

2. If no well be commenced on said land on or before one (1) year from date hereof, this lease shall terminate as to both parties unless Lessee, on or before one (1) year from this date, shall pay or tender to Sugg an amount of money equal to One Dollar ($1.00) per acre or deposit such sum to the account of Andrew A. Sugg with The First National Bank of San Angelo, Texas, as a depository bank and to Farmar an amount of money equal to One Dollar ($1.00) per acre or deposit such amount with The Central National Bank of San Angelo, San Angelo, Texas, for deposit to the Philip D. Farmar agent, Account No. 204-424-2, which banks are hereby respectively designated as depository banks and their respective successors shall continue as a depository regardless of changes of ownership of said lands, which sum of money shall operate as rental and cover the privilege of deferring the commencement of a well for one (1) year from said date; provided, however, that the commencement of a well shall abate the necessity for the next annual payment or tender of delay rentals to perpetuate this lease only as to six hundred forty areas per well commenced. In each instances the sum of money to be paid or deposited in lieu of drilling shall be determined by multiplying the stated price per acre times the number of net

mineral acres owned respectively by Sugg and by Farmar and on which a well has not been commenced. In like manner and upon like payments or tenders, the commencement of drilling operations of a well may be further deferred for like periods of one (1) year each during the primary term hereof. A well shall not be considered to have been commenced unless the same is thereafter drilled with reasonable and continuous diligence. The drilling of a well, even if the same is a dry hole, shall abate the payment of delay rentals only as to six hundred forty (640) acres. For purposes of paying delay rentals the acreage shown opposite each tract of land in Exhibit "A" shall be conclusively presumed to be the number of acres contained in that particular tract.

3. Should the first well or subsequent successive wells drilled on the above described land be a dry hole or dry holes, this lease shall terminate as to both parties, unless, on or before the rental paying date next ensuing after the date of completion of such dry hole the Lessee commences the drilling of another well or resumes payment of annual delay rentals in the same manner as provided in Paragraph No. 2 of this lease. If at the expiration of the primary term or any other expiration of this lease, Lessee is then engaged in drilling operations, this lease shall remain in force as to the producing unit on which such well is situated so long as such operations continue thereon, and if such well results in production, then so long thereafter as oil or gas is produced from such producing unit, subject, however, to the depth limitations set out in Paragraph 20 of this lease.

4. Except for surface water or water from Lessor's water wells, Lessee shall have the right to use free of cost, gas, oil and water produced from said lands for all operations except that use of fresh water is limited to use of same for drilling operations. Any earthen pits shall be lined in such a manner as to prevent any substance placed therein from penetrating through such lining. At no time shall substantial quantities of salt water or other deleterious substances be stored or placed in surface pits, and all pits into which salt water or other deleterious substances is temporarily placed shall be constructed and sealed in a water-tight man-

ner so that the same cannot escape through or over such pits, and if substantial quantities of salt water are produced, the same shall be reinjected in a formation which is below all fresh water bearing formations, and in all events salt water and other deleterious substances shall be handled in such a manner so as not to pollute fresh water. When requested by Lessor, Lessee shall bury all pipelines when the ditch therefor can be dug with the use of a conventional ditching machine. Where such cannot be so accomplished, the pipe will be buried at all road, fence and livestock and/or game trail crossings and in all other areas the pipeline will be partially buried or at least covered to the extent that the pipe will not be exposed even though the same is lying on the surface, and to accomplish this, Lessee may grade up dirt adjacent to the pipeline so long as there is no substantial change of grade and erosion is not caused thereby. Lessee shall maintain such pipelines in order to prevent erosion or exposure thereof. No well shall be drilled nearer than one thousand three hundred twenty feet (1,320) to any house, barn, windmill, watering facility, pens, corrals or air strip now on said premises without the written consent of Lessor, and no well shall be drilled nearer than one-half (½) mile from the enclosure surrounding the OH Triangle Headquarters situated in the southeast corner of Survey 1894 E. Heinrich. Before a proposed well is commenced in either Survey 1983, D. Verbene; 1894, E. Heinrich; 1895, E. W. Weygand or 3067, Block 28, H&TC RR Co., Lessee and Lessor shall confer with a view toward establishing a development pattern for those surveys which is reasonably calculated to produce the least interference with Lessor's use and enjoyment of the OH Triangle Headquarters by avoiding as far as reasonably possible the drilling of well or wells within the prohibited distance.

5. All equipment, mobile or stationary, of every kind and character that will touch the ground, prior to entry on the premises, shall first be thoroughly washed and cleaned to the extent that such equipment is not reasonably susceptible of introducing bitterweed or other noxious weeds on the premises. By way of illustration but not limitation, such

equipment shall include dirt moving equipment, self-propelled well servicing units, sub-structures for drilling rigs, logging trucks, oil well cementing trucks and equipment, tractors and equipment carriers such as floats, trailers and all other dual wheel vehicles. If, notwithstanding these precautions, bitterweed or other noxious weeds should appear on or adjacent to any site of Lessee's operation, including roads used, then Lessee will take steps necessary to eliminate the bitterweed or other noxious weeds and for failure to perform this particular obligation, Lessee shall be liable for the reasonable cost of complying with the same. This provision is not intended to make Lessee an unlimited insurer against bitter or noxious weeds intrusion on Lessor's ranch but to the contrary is intended to be applicable to those situations where it is reasonably evident that such intrusion was caused or aggravated by Lessee's operation.

6. Prior to the commencement of any operations on the lease, Lessee shall confer with a representative of Lessor with a view toward agreeing upon suitable locations for drilling operations, access roads, tank batteries, metering stations, gathering and flow lines and the like. Such locations shall be in such positions as will cause the least interference with ranching operations, taking into account environmental and ecological considerations, the cost of construction, and the geological need for a location in a particular site. Lessor's consent for such location shall not be unreasonably withheld. Lessee will make every reasonable effort to give Lessor as much advance notice of its planned exploration and development program in order to permit Lessor and Lessee, or their representatives, to make on the ground plans for such locations. Lessor will use every reasonable effort to be available or have a representative available in order to meet with Lessee or Lessee's representatives within a reasonable time after notice. If emergency situations arise, each party will use every reasonable effort to accommodate the other party in order to achieve the purposes for which this lease is made.

7. Before using any road (existing or new) on the premises, Lessee shall first cause the same to be constructed

with compacted caliche of sufficient thickness to make the same an all-weather road, and such roads shall be watered with sufficient frequency to prevent the raising of excessive dust and the same shall be maintained in good passable condition, including adding additional caliche when necessary. No material used in road construction shall be brought in from off the premises. Any road constructed on the premises shall remain a private road only for the purpose of exploring, developing, producing and transporting oil and gas and products therefrom from the premises solely for the benefit of Lessee and those furnishing third party services to Lessee and for the use of Lessor and Lessor's permittees. No such roads shall be used as a primary means of ingress and egress to lands owned by third parties and shall not be so used for any such purpose without Lessor's consent. At each point where a road crosses a fence, Lessee will install, at Lessor's election, either a cattle guard, gate or combination cattle guard and gate. If a gate is elected, Lessee may install a cattle guard in addition to the gate. Prior to cutting a fence, Lessee will install on each side of the proposed cut a braced-end type post conforming with the recommended practices of the Soil Conservation Service and the existing fence will be firmly fixed as taut and as without sag as prior to being cut. Upon request by Lessor, or any one of them, the gates will be kept locked at all times except when traffic is passing therethrough. Upon any cessation of use of any such road by Lessee, at Lessor's request all caliche placed on such road will be removed and returned to the pit from which it came, however, Lessee, in lieu of removing such caliche may pay Lessor on the basis, of Five Thousand Two Hundred Fifty Dollars ($5,280.00) per mile of caliche road to be removed.

8. While operations are being conducted hereunder, all areas of operation and areas adjacent thereto, including but not limited to roads, will be kept free from junk, paper, cans, old [illegible], trash and all other forms of debris and within a reasonable time after drilling operations on each site are completed, the area will be finally cleansed and policed and, except to the extent needed to produce a well, caliche pads, earthen pits and structures shall be removed

to the end that all objects and structures foreign to the natural condition of the land will be eliminated. Upon any final abandonment of an area the same will promptly be policed and restored as herein provided. If the caliche used in operations cannot be placed in pits or similar excavations at the location, and then covered with topsoil, then the excess will be returned to the source pits. For failure to perform these covenants, the Lessee and each immediate and remote Assignee, shall be jointly and severally liable in Irion County, Texas, to Lessor for the reasonable cost of complying with these provisions. Lessee shall have the right to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing, at any time up to one hundred twenty (120) days after the termination of this lease. The following schedule of damages to be paid by Lessee to the owner of the surface as well as other damage and liquidated payments provided for in this lease shall be applicable during the primary term. After the expiration of the primary term the damages and liquidated payments shall be paid in accordance with the damages generally paid in that vicinity at that time, but in no event shall be less than the amount herein specified. The amounts herein set out are for the usual and customary damages reasonably expected to result from prudent and reasonable oil and gas operations and do not cover any unusual damages such as, by way of illustration but not limitation, damages to livestock, improvements, persons and the like. The damages herein provided shall be paid prior to the commencement of operations:

a. Two Dollars ($2.00) per rod multiplied by the length of a road proposed to be used for the first time by Lessee;

b. Five Hundred Dollars ($500.00) per location not covering more than two (2) acres;

c. One Dollar ($1.00) per road for flow and gathering lines;

d. Five Hundred Dollars ($500.00) per tank battery site covering not more than two (2) acres.

Any damages not specified in the foregoing schedule shall be paid on the basis of the customary amounts paid in that vicinity. Any caliche used in construction of roads or pads

for well locations and tank batteries shall be taken from the pit site designated by Lessor and the caliche shall be purchased from the owner of the surface on the basis of Fifty Cents (50¢) per cubic yard. So long as the haul distance of caliche is not unreasonably long, caliche shall be taken from existing pits.

9. Any obligation herein imposed upon Lessee shall likewise apply to any of Lessee's agents, servants, employees, contractors, representatives, parties furnishing third party services, or anyone coming on the premises pursuant to this Lease and Lessee shall be obligated to enforce compliance by such other parties and shall be liable to Lessor for any failure of compliance by any such parties. Lessee shall prohibit anyone acting under Lessee from coming on the premises with firearms, either in person or in vehicles or equipment and shall enforce this prohibition to the extent that there shall be full compliance therewith. Likewise, Lessee shall prohibit hunting of any nature on Lessor's ranch under lease herein by any party coming on the premises under this lease. Expressly this lease shall never be construed so as to permit Lessee or those acting under Lessee or third parties to engage in picnicing, sight-seeing or other recreational activities on the premises and Lessee shall use all reasonable efforts to prevent the same.

10. In the event production of oil or gas on the leased premises after once obtained shall cease from any cause at the expiration of the primary term hereof or at any time or times thereafter, this lease shall not terminate if the Lessee commences additional drilling or reworking operations within sixty (60) days thereafter, and the lease shall remain in full force and effect so long as such operations continue in good faith and in workmanlike manner without interruptions totaling more than sixty (60) days during any one such operation; and of such drilling or reworking operations resold in the production of oil or gas, the lease shall remain in full force and effect so long as oil or gas is produced therefrom in paying quantities.

11. Should Lessee be prevented from complying with any express or implied convenant of this lease, from conducting drilling operations thereon, or from producing oil or gas

therefrom, after effort made in good faith, by reason of war, rebellion, riots, strikes, acts of God, or by failure, accident or breakdown, mechanical or otherwise, of producing, treating, gathering or delivery facilities, plants or pipelines, including the necessity of making repair or alterations thereof, or any valid order, rule or regulation of government authority, then while so prevented, Lessee's obligation to comply with such covenant shall be suspended and Lessee shall not be liable for damages for failure to comply therewith, provided, however, that unless this lease is then being maintained in force by some other provisions hereof, nothing contained in this Paragraph 11 shall be construed to suspend the payment of delay rentals in order to maintain this lease in effect during the primary term in the absence of such drilling or reworking operations or production of oil or gas.

12. If the estate of either party hereto is assigned—and the privilege of assigning in whole or in part is expressly allowed—the covenants hereof shall extend to their heirs, executors, administrators, successors, or assigns, but no change in the ownership of the land or assignment of rentals or royalties shall be binding on the Lessee until after the Lessee has been furnished with a written transfer or assignment, or a certified copy thereof; and it is hereby agreed that in the event this lease shall be assigned as to a part or as to parts of the above described lands and the assignee or assignees of such part or parts shall fail or make default in the payment of the proportionate part of the rents due from him or them, such default shall not operate to defeat or affect this lease insofar as it covers the part or parts of said lands upon which the said Lessee or any assignee thereof shall make due payment of said rental.

13. Lessee may, at any time, and from time to time, execute and deliver to the Lessor or place of record, a release or releases covering any portion or portions of the above described premises, and thereby surrender this lease as to such portion or portions, and be relieved of all subsequent obligations as to acreage surrendered. In the event any part of this lease is surrendered, as above provided, the delay rental then payable hereunder shall thereupon be re-

duced in the proportion that the acreage surrendered bears to the acreage which was covered by this lease immediately prior to such surrender, provided such release shall not thereby relieve the Lessee of any liabilities which may have accrued in connection with the lease prior to the surrender of such acreage. If a partial release or releases should result in the route of ingress and egress to the retained lands being across Lessor's other lands, including those which had been previously covered by this lease, and such route is unreasonably inconvenient or burdensome to Lessor, then Lessee and Lessor shall, in a manner similar to that set out in Paragraph 6 above, arrange for Lessee to relocate such roads.

14. Lessee, at its sole cost and expense, shall be responsible for all future abstract expense for separately supplementing Lessor's abstracts for the inclusion therein of any and all instruments directly resulting from or rising out of the recording of this lease. This obligation shall be separately applicable to each separately numbered tract covered hereby, and this obligation shall not finally terminate until such time as all releases have been filed which will terminate this lease as to all lands covered hereby; however, this obligation shall terminate as to each separately numbered tract when all releases necessary to release such tract from this lease have been filed and included in supplemental abstract for that tract. This obligation shall not only be that of the original Lessee but also of each Assignee of any interest herein of any tract covered hereby and same shall be joint and several and may be asserted by Lessor, Lessor's personal representatives, heirs or assigns against the original Lessee or any Assignee or at the option or Lessor against all Assignees.

15. If said Lessor owns a lesser interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said Lessor only in proportion which Lessor's interest bears to the whole and undivided fee, provided further however that this lease is made subject to all valid and outstanding oil, gas and mineral conveyances as well as royalty conveyances and agreements affecting the

land covered hereby now appearing of legal record in the office of the County Clerk of the County wherein the above lands are situated.

16. If for any reason during or after the primary term, a well or wells located on the above described land and capable of producing gas, gas condensate, or gas and gas condensate in paying quantities is or are shut in for a period of sixty (60) consecutive days, during which time oil and gas is not otherwise being produced hereunder, Lessee may on or before the expiration of said sixty-day period pay or tender to Sugg or deposit to the credit of Sugg in the depository bank as specified in Paragraph 2 above a sum of money equal to One Dollar ($1.00) if during the primary term or Five Dollars ($5.00) if after the primary term multiplied by the net number of mineral acres owned by Sugg in the tract hereinafter described and to Farmer or deposit to the credit of Farmer in the depository bank as specified in Paragraph 2 above a sum of money equal to One Dollar ($1.00) if during the primary term or Five Dollars ($5.00) if after the primary term multiplied by the net number of mineral acres owned by Farmar in the tract hereinafter described, with the banks specified in Paragraph 2 above and their respective successors acting as respective agents for Lessor and such banks shall continue as the depository for all such payments regardless of any devolution, change or division of the ownership of said lands; and if such tender, payments or deposits are made, it shall be considered under the provisions of this lease that gas is being produced from six hundred forty (640) acres of the leased premises on which such gas well is situated if such is completed in the Canyon formation or deeper and three hundred twenty (320) acres if such gas is being produced from a formation above the top of the Canyon formation, for one (1) year from the date such well was shut-in, and upon a like payment on or before such day each succeeding year it will be considered under all of the provisions of this Lease that gas is being produced from such six hundred forty (640) acres of land [or three hundred twenty (320) acres as the case may be] in paying quantities for the year immediately following. This privilege of paying a gas shut-in royalty as constructive produc-

tion of gas, under no circumstances, shall extend beyond December 1, 1985, unless a gas well is completed after December 1, 1985, in which case such payment, tender or deposit may be made for one (1) additional year ending twelve (12) months after such well is shut in.

17. The following terms have the following meanings herein:

(a) A producing or production unit is a tract of land in the shape of a square or a rectangle and wherever possible shall be a regular section of land or a regular subdivision of a section of land, e.g. a ½, ¼ or a fraction or part thereof and on which is located a well producing (actually or constructively) oil or gas and contains the following amount of acreage, with a ten percent (10%) tolerance:

(1) Eighty (80) acres if the well is producing oil from a formation above the top of the Canyon formation

(2) One hundred sixty (160) acres if the well is producing oil from the Canyon formation or deeper.

(3) Three hundred twenty (320) acres if the well is producing gas from a formation above the top of the Canyon formation.

(4) Six hundred forty (640) acres if the well is producing gas from the Canyon formation or deeper.

(b) A Drilling Block shall contain not more than three thousand two hundred (3,200) acres (with 10% tolerance) of contiguous land and insofar as reasonably practical shall consist of not more than five (5) sections of land. If a tract of land covered hereby is not contiguous to any other tract covered hereby, then such segregated tract may be included in a Drilling Block with the nearest noncontiguous tract covered by this lease. A section of land means a tract of land which is identified by a section or survey number, usually a block number, and a railway or original grantee designation and usually is in the form of a square and contains six hundred forty (640) acres, more or less, of land.

(c) Spud or commence a well means the actual commencement of the cutting of a hole and thereafter continued with reasonable and continuous diligence to a

depth sufficient to test a formation known to be potentially productive of oil or gas.

(d) Completion of a well is the day that the last of the drilling, production or completion rig or unit moves off the hole after the well is first drilled.

18. At the expiration of the primary term of this Lease, this Lease shall terminate as to all lands covered hereby and not included in a producing unit or in a Drilling Block or Blocks unless Lessee shall pay, tender or deposit to Sugg, as an advance royalty, an amount of money equivalent to Ten Dollars ($10.00) per acre multiplied by the net number of mineral acres owned by Sugg, and an amount of money equivalent to Ten Dollars ($10.00) per acre multiplied by the net number of mineral acres owned by Farmar and as to which Lessee elects to extend this lease. Such sum of money may be deposited to the appropriate depository bank as specified in Paragraph 2 hereof. Contemporaneously with such payment, Lessee shall designate, by appropriate legal description, the lands for which such payment is being made and contemporaneously with such payment, tender or deposit shall furnish Lessor written notice of such designation, mailed to P.O. Box 573, San Angelo, Texas 76901 or at such address as Lessor may in writing designate. If such payment is so made, then this Lease shall be extended as to the designated lands for one (1) year from said date. In like manner and upon like payments, tenders or deposits, this Lease may be further extended for like periods of one (1) year successively until December 1, 1985. During the time this Lease is being extended by the payment of such advance royalties, as to any lands which were designated as those to which this Lease is to be extended by the payments of an advance royalty [Ten Dollars ($10.00) per acre per year for all Lessors], this Lease may be extended beyond the next succeeding anniversary date only by the same being dedicated to a producing unit or by the payment of advance royalty as herein provided. On each anniversary date of this Lease after the primary term, this Lease shall terminate as to all lands which are not included in a production unit on which is located a producing (actually or constructively) well, included in a Drilling

Block which is being perpetuated by continuous drilling or included in the designated lands for which the Ten Dollar ($10.00) advance royalty per acre is being paid.

19. Before the expiration of the primary term, Lessee may select any number of Drilling Blocks as Lessee may elect, and, upon so doing, shall furnish Lessor a description of the land, included in each Drilling Block so selected. As to each Drilling Block, this Lease shall not terminate at the expiration of the primary term if within ninety (90) days after the expiration of the primary term Lessee commences a well on some portion of the land covered in that Drilling Block and within ninety (90) days after its completion commences another well and thereafter with no lapse of time of more than ninety (90) days between the completion of a well and the commencement of another well continues the drilling of additional wells until all lands in the Drilling Block contain a well which is actually or constructively producing oil or gas and to which well there has been dedicated a producing unit. If at any time Lessee fails to commence a well on some portion of a Drilling Block within ninety (90) days after the completion of the next preceding well in that block, then this Lease shall terminate as to all the lands in the Drilling Block, except for the lands included in a producing unit. The right to extend this Lease by the continuous drilling program herein set out, unless sooner terminated, shall terminate on December 1, 1985. Upon any termination of this Lease during the extended term just described, production from any well production from a formation above the top of the Canyon formation shall extend the Lease vertically from the surface to the base of the formation from which production is being obtained in that well unless there is actual or constructive production from a well in that Drilling Block which is producing from the Canyon formation or deeper, in which case this Lease shall be extended as to all of the producing units in that Block and as to all depths in each unit.

20. Except for any lands which are included in a producing unit on which is located a gas well which was completed in the last year of the extended term of this Lease (December 1, 1984 to December 1, 1985) and for which a gas shut-

in royalty payment has been properly made, this Lease shall terminate on December 1, 1985, as to all lands not dedicated to production under the applicable spacing regulations of the Railroad Commision of Texas, or its successor, and further, if a well is completed in and producing from a formation above the top of the Canyon Formation, then this Lease shall also terminate as to all zones, formations and horizons which are deeper than one hundred feet (100) below the depth of the deepest formation from which production is then being obtained in that well. If thereafter the Railroad Commission of Texas, or its successor, should change the spacing rules, and thereby reduce the size of proration units, then Lessee shall have ninety (90) days from the effective date of such rule change to commence a well and pursue a continuous drilling program with no interval of more than ninety (90) days from the date of completion of one (1) well until the commencement of a succeeding well, with the definition heretofore given being applicable to this situation, and if Lessee fails to commence a well within ninety (90) days from the date of completion of the next preceding well, then at that time this Lease shall terminate as to all acreage not dedicated to a production unit under the applicable spacing regulations of the Railroad Commission of Texas. After the expiration of the extended term, production from a well shall perpetuate this Lease only as to the acreage dedicated to that well under the applicable spacing regulations of the Railroad Commission of Texas, subject to the provision of the sixty (60) day re-working clause.

21. The fact that the Lease is signed by the Lessors and cover land the ownership of which differs between the Lessors shall not be considered to have the effect of unitization or communitization of the ownership of the lands covered but to the contrary, the royalty and other benefits reserved by the Lessor, inure only to the owner of such lands and in proportion to each parties' ownership therein.

22. If Lessee engages in drilling operations with the use of air or gas, then during all periods of operation, Lessee shall have a de-duster or dust eliminator in operating order and in operation.

23. Lessor hereby warrants and agrees to defend the title to the lands herein described and agrees that the Lessee shall have the right at any time to redeem for Lessor, by payment, any mortgages, taxes, or other liens on the above described lands, in the event of default of payment by Lessor, and be subrogated to the rights of the holder thereof.

24. Any notice herein required may be given in the following manner:

To Sugg at P.O. Box 573, San Angelo, Tom Green County, Texas 76901—telephone (915) 655-4486

To Farmar at 1410 Warwick Lane, Newport Beach, California 92660—telephone (714) 646-1426

To Allied Chemical Corporation or Florida Gas Exploration Company at the respective addresses shown above.

IN WITNESS WHEREOF this Oil and Gas Lease is executed effective December 1, 1975.

/s/ ANDREW SUGG
ANDREW A. SUGG

SUGG

/s/ PHILIP D. FARMAR
PHILIP D. FARMAR

/s/ NANCY FARMAR WARFIELD
NANCY FARMAR WARFIELD

/s/ ANDREA FARMAR BJELDANES
ANDREA FARMAR BJELDANES

/s/ PETER D. FARMAR
PETER D. FARMAR

/s/ PHILIP D. FARMAR
PHILIP D. FARMAR, as Testimentary Trustee under the Will of Samie June S. Farmar, Deceased, for the benefit of Steven S. Farmar

FARMAR

THE STATE OF TEXAS)(
COUNTY OF TOM GREEN)(

BEFORE ME, the undersigned authority, on this day personally appeared ANDREW A. SUGG, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this 14 day of December, 1975

/s/ W. TRUETT SMITH

W. TRUETT SMITH
Notary Public in and for Tom Green County, Texas

THE STATE OF CALIFORNIA)(
COUNTY OF ORANGE)(

BEFORE ME, the undersigned authority, on this day personally appeared PHILIP D. FARMAR, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed and in the capacity therein stated.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this 15 day of December, 1975

/s/ JANANNE HOLDEN

JANANNE HOLDEN
Notary Public in and for Orange County, California

THE STATE OF CALIFORNIA)(
COUNTY OF MARIN)(

BEFORE ME, the undersigned authority, on this day personally appeared NANCY FARMAR WARFIELD, known to me to be the person whose name is subscribed to the foregoing insrument, and acknowledged to me that she executed the same for the purposes and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this 16 day of December, 1975

/s/ K. L. BOOSEY

K. L. BOOSEY
Notary Public in and for Marin County, California

THE STATE OF CALIFORNIA)(
COUNTY OF LOS ANGELES)(

BEFORE ME, the undersigned authority, on this day personally appeared ANDREA FARMAR BJELDANES, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that she executed the same for the purposes and consideration therein expressed.

GIVEN UNDER MY AND AND SEAL OF OFFICE this 18th day of December, 1975

/s/ RUTH H. ALFARMER

RUTH H. ALFARMER
Notary Public in and for Los Angeles County, California

THE STATE OF CALIFORNIA)(
COUNTY OF SAN DIEGO)(

BEFORE ME, the undersigned authority, on this day personally appeared PETER D. FARMAR, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this 15 day of December, 1975

/s/ JANANNE HOLDEN

JANANNE HOLDEN
Notary Public in and for San Diego County, California

EXHIBIT "A"

December 1, 1975

OIL AND GAS LEASE
ANDREW A. SUGG, PHILIP D. FARMAR, ET AL, LESSOR
ALLIED CHEMICAL CORPORATION AND FLORIDA GAS EXPLORATION COMPANY, LESSEE

All of the following described lands and interests therein in Irion County, Texas:

Tract No.	Survey No.	Abstract No.	Lessor's Gross Mineral Acres	Andrew A. Sugg Net Mineral Acres	Philip D. Farmar Net Mineral Acres	Combined Net Mineral Acres Of 4 Farmar Children With Each Owning ¼th Thereof
		Following Lands in Block 6, H.&T.C. RR Co.:				
1	1	312	493	246.5	246.5	
2	2	951	640	320	320	
3	3	313	640	320	320	
4	4	1255; 897; 1228	640	320	320	
5	5	314	640	320	320	
6	6	916	640	320	320	
7	7	315	640	320	320	
8	9	316	640	320	320	
9	11	317	640	320	320	
10	12	915	640	320	320	
11	13	318	640	320	320	
12	14	1148	640	320	320	
13	15	319	640	320	320	
14	19	321	640	320	320	
15	20	950	643	321.5	321.5	
16	21	322	640	320	320	
17	22	917	642	321	321	
18	23	323	640	320	320	
19	24	1265	640	320	320	
20	25	324	640	320	320	
21	26	914	646	323	323	
22	27	325	640	320	320	
23	29	326	640	320	320	
24	38	976	642.8	321.4	321.4	
25	39	331	640	320	320	
26	40	1266	640	320	320	
27	41	332	640	320	320	
		Following Lands in Block 28, H.&T.C. RR Co.:				
28	3057	195	642.2	321.1	321.1	
29	E/23058	898	362.75	181.37	181.38	
30	3059	205	646.1	323.1	323.0	
31	3060	899	791.3	395.6	395.7	
32	¾ths interest in 3061	204	501.8	334.5	83.6	83.7
33	3067	192	662	331	331	
34	3069	203	690.6	345.3	345.3	
35	3070	924	642.3	321.2	321.1	
36	3071	197	644	322	322	

Tract No.	Survey No.	Abstract No.	Lessor's Gross Mineral Acres	Andrew A. Sugg Net Mineral Acres	Philip D. Farmar Net Mineral Acres	Combined Net Mineral Acres Of 4 Farmar Children With Each Owning ¼th Thereof
37	¾ths interest in 3072	927	480	320	80	80
38	¾ths interest in 3073	202	480	320	80	80
39	3089	1177	190	95	95	
		Following Lands in Block 1, H.&T.C. RR Co.:				
40	4	1039	640	320	320	
41	5	233	640	320	320	
42	E/2 6	942	320	160	80	80
43	11	236	640	320	160	160
44	12	752	640	320	160	160
45	S/2 17	239	320	160	80	80
46	29	245	640	320	160	160
47	30	743	640	320	160	160
48	31	246	640	320	160	160
49	32	958	640	320	160	160
50	S. Pt.33	247	173	86.5	43.3	43.2
51	N/2 37	249	320	160	80	80
52	S/2 44	1061	320	160	80	80
53	S/2 45	253	320	160	80	80
54	46	770	640	320	160	160
55	47	254	640	320	160	160
56	48	1053	640	320	160	160
57	49	255	640	320	160	160
58	50	960	640	320	160	160
59	51	256	640	320	160	160
60	52	959	640	320	160	160
61	53	257	640	320	160	160
62	54	905	640	320	160	160
63	55	258	640	320	160	160
64	56	1063	640	320	160	160
65	57	259	640	320	160	160
66	67	264	640	320	160	160
67	69	265	640	320	160	160
68	70	1115	640	320	160	160
69	71	266	640	320	160	160
70	73	267	640	320	160	160
71	88	1112	640	320	160	160
72	89	275	640	320	160	160
		Following Lands which are not in Blocks:				
73	1898, D Verbene	643	640	320	320	
74	1894, E. Heinrich	162	640	320	320	
75	1895, E.W. Weygand	654	420	210	210	
76	1896 A. Wiman	657	320	160	160	
77	1897, A. Wiman	658	320	160	160	
78	3044, J. McNeese	466	640	320	320	
79	E. Pt., Sur. 2 D.C. Caldwell	1085	601.8	300.9	300.9	

JOINT EXHIBIT B

DEFERRED BONUS AGREEMENT

WHEREAS on December 1, 1975, ANDREW A. SUGG, and others, as Lessor, executed and delivered to ALLIED CHEMICAL CORORATION, 1330 Wilco Building, Midland, Texas 79701 and FLORIDA GAS EXPLORATION COMPANY, 2240 The 1100 Milam Building, Houston, Texas 77002, as Lessee, an Oil and Gas Lease covering lands in Irion County, Texas, which lands are described in Exhibit "A" attached hereto and made a part hereof.

WHEREAS the total consideration to ANDREW A. SUGG for the execution and delivery of such lease is One Million Fifty-seven Thousand Five Hundred Forty-three and 60/100 Dollars ($1,057,543.60), which, as part of the agreement between the parties, is to be paid as hereinafter provided.

NOW THEREFORE, for and in consideration of the premises, ALLIED CHEMICAL CORPORATION and FLORIDA GAS EXPLORATION COMPANY, jointly and severally, do hereby agree to pay to ANDREW A. SUGG the total sum of One Million Fifty-seven Thousand Five Hundred Forty-three and 60/100 Dollars ($1,057,543.60) as follows:

On or before December 25, 1975	$ 1,000.00
Between January 10 and January 20, 1976	528,271.80
Between January 10 and January 20, 1978	528,271.80
	$1,057,543.60

Such deferred sum shall bear no interest and shall be paid by bank cashier's check payable to ANDREW A. SUGG and delivered to him in person or mailed to him at P.O. Box 573, San Angelo, Texas 76901 or deposited to the account of Andrew A. Sugg in The First National Bank, San Angelo, Texas.

The right to receive the moneys herein provided to be paid to ANDREW A. SUGG is not assignable or transferable by ANDREW A. SUGG, but to the contrary, the same is personal and may be paid only to ANDREW A. SUGG or upon the death of ANDREW A. SUGG to the Estate of ANDREW A. SUGG. The contract rights herein given to

said ANDREW A. SUGG are not negotiable and the date of the payment of the obligations herein provided may not be accelerated.

In the event of an assignment of the Oil and Gas Lease, any unpaid balance due to ALLIED CHEMICAL CORPORATION and FLORIDA GAS EXPLORATION COMPANY to ANDREW A. SUGG shall never constitute a lien or an encumbrance of any nature, either express or implied, upon the rights, titles and properties passing to the Lessee under said lease, but the contrary, the obligations herein imposed upon ALLIED CHEMICAL CORPORATION and FLORIDA GAS EXPLORATION COMPANY are the joint and several obligations of said two parties, but such obligations are not secured.

EXECUTED in triplicate originals this 12th day of December, 1975.

/s/ ANDREW A. SUGG

ANDREW A. SUGG
Lessor

ALLIED CHEMICAL CORPORATION

By: A. A. BONNER, JR.*

A. S. BONNER, JR.

FLORIDA GAS EXPLORATION COMPANY

By: KENNETH E. MASTERS

KENNETH E. MASTERS
Vice President

**Executive Vice President*
Union Texas Petroleum

EXHIBIT "A"

December 1, 1975

OIL AND GAS LEASE
ANDREW A. SUGG, PHILIP D. FARMAR, ET AL, LESSOR
ALLIED CHEMICAL CORPORATION AND FLORIDA GAS EXPLORATION COMPANY, LESSEE

All of the following described lands and interests therein in Irion County, Texas:

Tract No.	Survey No.	Abstract No.	Lessor's Gross Mineral Acres	Andrew A. Sugg Net Mineral Acres	Philip D. Farmar Net Mineral Acres	Combined Net Mineral Acres Of 4 Farmar Children With Each Owning ¼th Thereof
		Following Lands in Block 6, H.&T.C. RR Co.:				
1	1	312	493	246.5	246.5	
2	2	951	640	320	320	
3	3	313	640	320	320	
4	4	1255; 897; 1228	640	320	320	
5	5	314	640	320	320	
6	6	916	640	320	320	
7	7	315	640	320	320	
8	9	316	640	320	320	
9	11	317	640	320	320	
10	12	915	640	320	320	
11	13	318	640	320	320	
12	14	1148	640	320	320	
13	15	319	640	320	320	
14	19	321	640	320	320	
15	20	950	643	321.5	321.5	
16	21	322	640	320	320	
17	22	917	642	321	321	
18	23	323	640	320	320	
19	24	1265	640	320	320	
20	25	324	640	320	320	
21	26	914	646	323	323	
22	27	325	640	320	320	
23	29	326	640	320	320	
24	38	976	642.8	321.4	321.4	
25	39	331	640	320	320	
26	40	1286	640	320	320	
27	41	332	640	320	320	
		Following Lands in Block 28, H.&T.C. RR Co.:				
28	3057	195	642.2	321.1	321.1	
29	E/2 3058	800	362.75	181.37	181.38	
30	3059	205	646.1	323.1	323.0	
31	3060	889	791.3	395.6	395.7	
32	¼ths interest in 3061	204	501.8	334.5	83.6	83.7
33	3067	192	662	331	331	
34	3069	203	690.6	345.3	345.3	
35	3070	924	642.3	321.2	321.1	
36	3071	197	644	322	322	

Tract No.	Survey No.	Abstract No.	Lessor's Gross Mineral Acres	Andrew A. Sugg Net Mineral Acres	Philip D. Farmar Net Mineral Acres	Combined Net Mineral Acres Of 4 Farmar Children With Each Owning ¼th Thereof
37	¾ths interest in 3072	927	480	320	80	80
38	¾ths interest in 3073	202	480	320	80	80
39	3089	1177	190	95	95	
		Following Lands in Block 1, H.&T.C. RR Co.:				
40	4	1039	640	320	320	
41	5	233	640	320	320	
42	E/2 6	942	320	160	80	80
43	11	236	640	320	160	160
44	12	752	640	320	160	160
45	S/2 17	239	320	160	80	80
46	29	245	640	320	160	160
47	30	743	640	320	160	160
48	31	246	640	320	160	160
49	32	958	640	320	160	160
50	S. Pt.33	247	173	86.5	43.3	43.2
51	N/2 37	249	320	160	80	80
52	S/2 44	1061	320	160	80	80
53	S/2 45	253	320	160	80	80
54	46	770	640	320	160	160
55	47	254	640	320	160	160
56	48	1053	640	320	160	160
57	49	255	640	320	160	160
58	50	960	640	320	160	160
59	51	256	640	320	160	160
60	52	959	640	320	160	160
61	53	257	640	320	160	160
62	54	905	640	320	160	160
63	55	258	640	320	160	160
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65	57	259	640	320	160	160
66	67	264	640	320	160	160
67	69	265	640	320	160	160
68	70	1115	640	320	160	160
69	71	266	640	320	160	160
70	73	267	640	320	160	160
71	88	1112	640	320	160	160
72	89	275	640	320	160	160
		Following Lands which are not in Blocks:				
73	1890, D Verbene	643	640	320	320	
74	1894, E. Heinrich	162	640	320	320	
75	1896, E. W. Weygand	654	420	210	210	
76	1898 A. Wiman	657	320	160	160	
77	1897, A. Wiman	658	320	160	160	
78	3044, J. McNeese	468	640	320	320	
79	E. Pt., Sur. 2 D.C. Caldwell	1085	601.8	300.9	300.9	

JOINT EXHIBIT C
DEFERRED BONUS AGREEMENT

WHEREAS on December 1, 1975, PHILIP D. FARMAR, NANCY FARMAR WARFIELD (formerly called Nancy Farmar), ANDREA FARMAR BJELDANES (formerly called Andrea Farmar), PETER D. FARMAR, and PHILIP D. FARMAR, as Testamentary Trustee under the Will of Sammie June S. Farmar, Deceased, for the benefit of Steven S. Farmar, herein collectively called "Farmar", and others, as Lessor, executed and delivered to ALLIED CHEMICAL CORPORATION, 1300 Wilco Building, Midland, Texas 79701 and FLORIDA GAS EXPLORATION COMPANY, 2240 The 1100 Milam Building, Houston, Texas 77002, as Lessee, an Oil and Gas Lease covering lands in Irion County, Texas, which lands are described in Exhibit "A" attached hereto and made a part hereof.

WHEREAS the total consideration to Farmar for the execution and delivery of such lease is One Million Thirty-five Thousand Six Hundred Fifteen and 16/100 Dollars ($1,035,615.16), which, as part of the agreement between the parties, is to be paid as hereinafter provided.

NOW THEREFORE, for and in consideration of the premises, ALLIED CHEMICAL CORPORATION and FLORIDA GAS EXPLORATION COMPANY, jointly and severally, do hereby agree to pay to PHILIP D. FARMAR, NANCY FARMAR WARFIELD (formerly called Nancy Farmar), ANDREA FARMAR BJELDANES (formerly called Andrea Farmar), PETER D. FARMAR, and PHILIP D. FARMAR, as Testamentary Trustee under the will of Sammie June S. Farmar, Deceased, for the benefit of Steven S. Farmar, the total sum of One Million Thirty-five Thousand Six Hundred Fifteen and 16/100 Dollars ($1,035,615.16) as follows:

On or before December 25, 1975	5,000.00
Between January 10 and January 20, 1976	257,653.90
Between January 10 and January 20, 1977	257,653.90
Between January 10 and January 20, 1978	257,653.90
Between January 10 and January 20, 1979	257,653.90
	$1,035,615.60

The above sum of money and each installment thereof shall be owned in the following proportions:

Philip D. Farmar, Individually—18,326.78/23,013.68;
Nancy Farmar Warfield—¼ x 4,686,90/23,013.68;
Andrea Farmar Bjeldanes—¼ x 4,686.90/23,013.68;
Peter D. Farmar—¼ x 4,686.90/23,013.68;
Philip D. Farmar, as Testamentary Trustee under the Will of Sammie June S. Farmar, Deceased, for the benefit of Steven S. Farmar—¼ x 4,686.90/23,013.68:

however, for purposes of convenience between the parties just mentioned and for no other purpose, any moneys due hereunder shall be paid by bank cashier's check payable to PHILIP D. FARMAR, Agent, and delivered to PHILIP D. FARMAR at 1410 Warwick Lane, Newport Beach, California, or mailed to PHILIP D. FARMER, Agent, at P.O. Box 573, San Angelo, Tom Green County, Texas 76901 or deposited to the account of Philip D. Farmar, Agent, Account No. 204-424-2,in The Central National Bank of San Angelo, San Angelo, Texas.

The deferred sums of money to be paid herein shall not bear interest and the right to receive the moneys herein provided is not assignable by any of the parties entitled to receive the same, but to the contrary, such rights are personal to each of the parties entitled to receive the same and so long as all such parties are living the same shall be paid as herein provided; however, upon the death of any one of the parties entitled to receive the moneys, the deceased party's interest in the money shall be payable to the estate of the deceased and not otherwise. The contract rights herein given to the parties entitled to receive such sums are not negotiable and the date of payment of the obligations herein provided may not be accelerated.

In the event of an assignment of the Oil and Gas Lease, any unpaid balance due by ALLIED CHEMICAL CORPORATION and FLORIDA GAS EXPLORATION COMPA-

NY to Farmar shall never constitute a lien or an encumbrance of any nature, either express or implied, upon the rights, titles and properties passing to the Lessee under said lease, but to the contrary, the obligations herein imposed upon ALLIED CHEMICAL CORPORATION and FLORIDA GAS EXPLORATION COMPANY are the joint and several obligations of said two parties, but such obligations are not secured.

EXECUTED in triplicate originals this 12 day of December, 1975.

/s/ _____
PHILIP D. FARMAR

/s/ _____
NANCY FARMAR WARFIELD

/s/ _____
ANDREA FARMAR BJELDANES

/s/ _____
PETER D. FARMAR

/s/ _____
PHILIP D. FARMAR, as Testamentary Trustee under the Will of Sammie June S. Farmar, Deceased for the benefit of Steven S. Farmar

LESSOR

ALLIED CHEMICAL CORPORATION
A.S. BONNER, JR.*
FLORIDA GAS EXPLORATION COMPANY

/s/ _____
KENNETH E. MASTERS
Vice President

LESSEE

*Executive Vice President
Union Texas Petroleum Division

EXHIBIT "A"

December 1, 1975

OIL AND GAS LEASE
ANDREW A. SUGG, PHILIP D. FARMAR, ET AL, LESSOR
ALLIED CHEMICAL CORPORATION AND FLORIDA GAS EXPLORATION COMPANY, LESSEE

All of the following described lands and interests therein in Irion County, Texas:

Tract No.	Survey No.	Abstract No.	Lessor's Gross Mineral Acres	Andrew A. Sugg Net Mineral Acres	Philip D. Farmar Net Mineral Acres	Combined Net Mineral Acres Of 4 Farmar Children With Each Owning ¼th Thereof
		Following Lands in Block 6, H.&T.C. RR Co.:				
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2	2	951	640	320	320	
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8	9	316	640	320	320	
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17	22	917	642	321	321	
18	23	323	640	320	320	
19	24	1265	640	320	320	
20	25	324	640	320	320	
21	26	914	646	323	323	
22	27	325	640	320	320	
23	29	326	640	320	320	
24	38	976	642.8	321.4	321.4	
25	39	331	640	320	320	
26	40	1266	640	320	320	
27	41	332	640	320	320	
		Following Lands in Block 28, H.&T.C. RR Co.:				
28	3057	195	642.2	321.1	321.1	
29	E/23058	898	362.75	181.37	181.38	
30	3059	205	646.1	323.1	323.0	
31	3060	899	791.3	395.6	395.7	
32	¾ths interest in 3061	204	501.8	334.5	83.6	83.7
33	3067	192	662	331	331	
34	3069	203	690.6	345.3	345.3	
35	3070	924	642.3	321.2	321.1	
36	3071	197	644	322	322	

Tract No.	Survey No.	Abstract No.	Lessor's Gross Mineral Acres	Andrew A. Sugg Net Mineral Acres	Philip D. Farmar Net Mineral Acres	Combined Net Mineral Acres Of 4 Farmar Children With Each Owning ¼th Thereof
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38	¾ths interest in 3073	202	480	320	80	80
39	3089	1177	190	95	95	
		Following Lands in Block 1, H.&T.C. RR Co.:				
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41	5	233	640	320	320	
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43	11	236	640	320	160	160
44	12	752	640	320	160	160
45	S/2 17	239	320	160	80	80
46	29	245	640	320	160	160
47	30	743	640	320	160	160
48	31	246	640	320	160	160
49	32	958	640	320	160	160
50	S. Pt.33	247	173	86.5	43.3	43.2
51	N/2 37	249	320	160	80	80
52	S/2 44	1061	320	160	80	80
53	S/2 45	253	320	160	80	80
54	46	770	640	320	160	160
55	47	254	640	320	160	160
56	48	1053	640	320	160	160
57	49	255	640	320	160	160
58	50	960	640	320	160	160
59	51	256	640	320	160	160
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65	57	259	640	320	160	160
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67	69	265	640	320	160	160
68	70	1115	640	320	160	160
69	71	266	640	320	160	160
70	73	267	640	320	160	160
71	88	1112	640	320	160	160
72	89	275	640	320	160	160
		Following Lands which are not in Blocks:				
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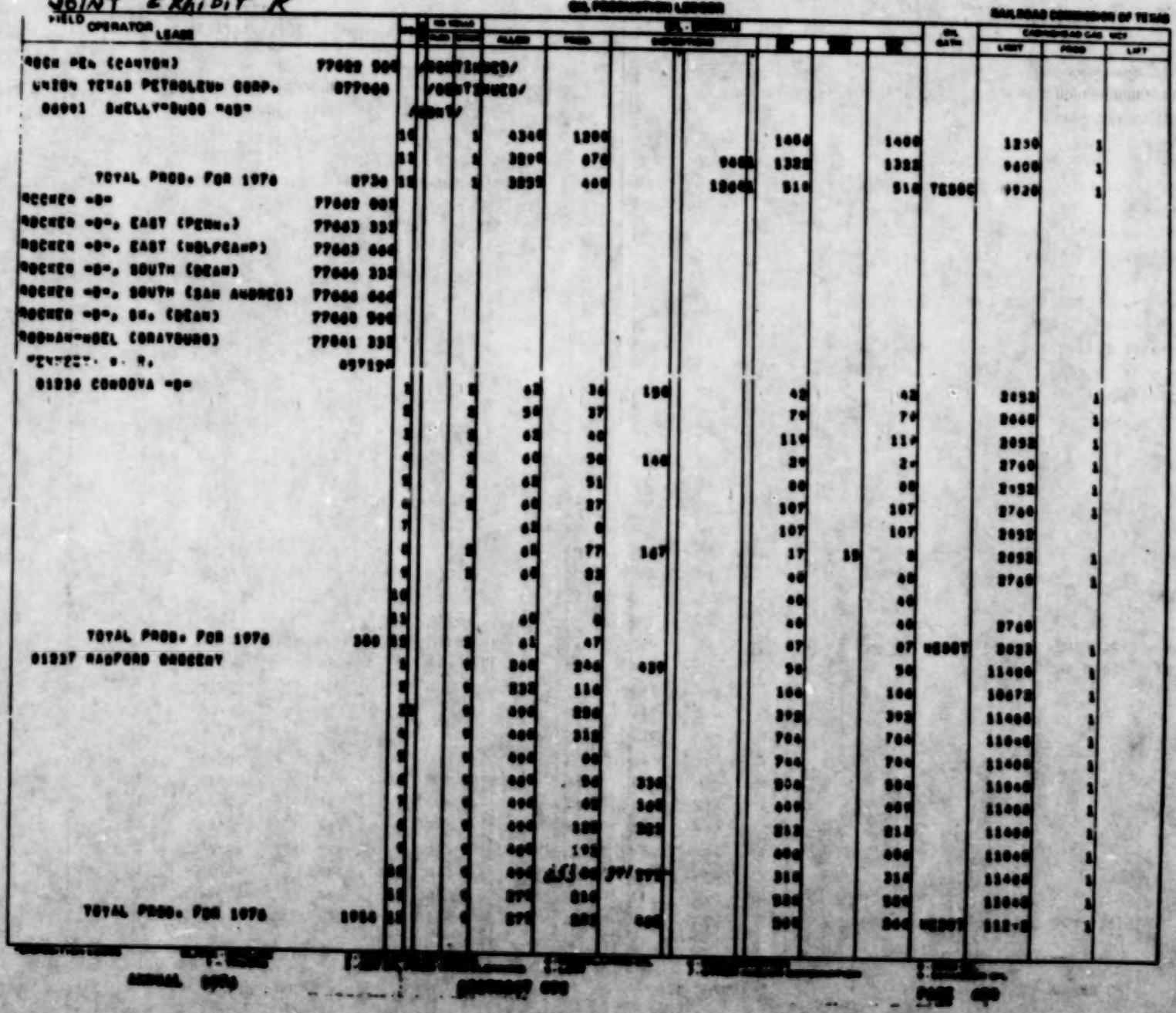
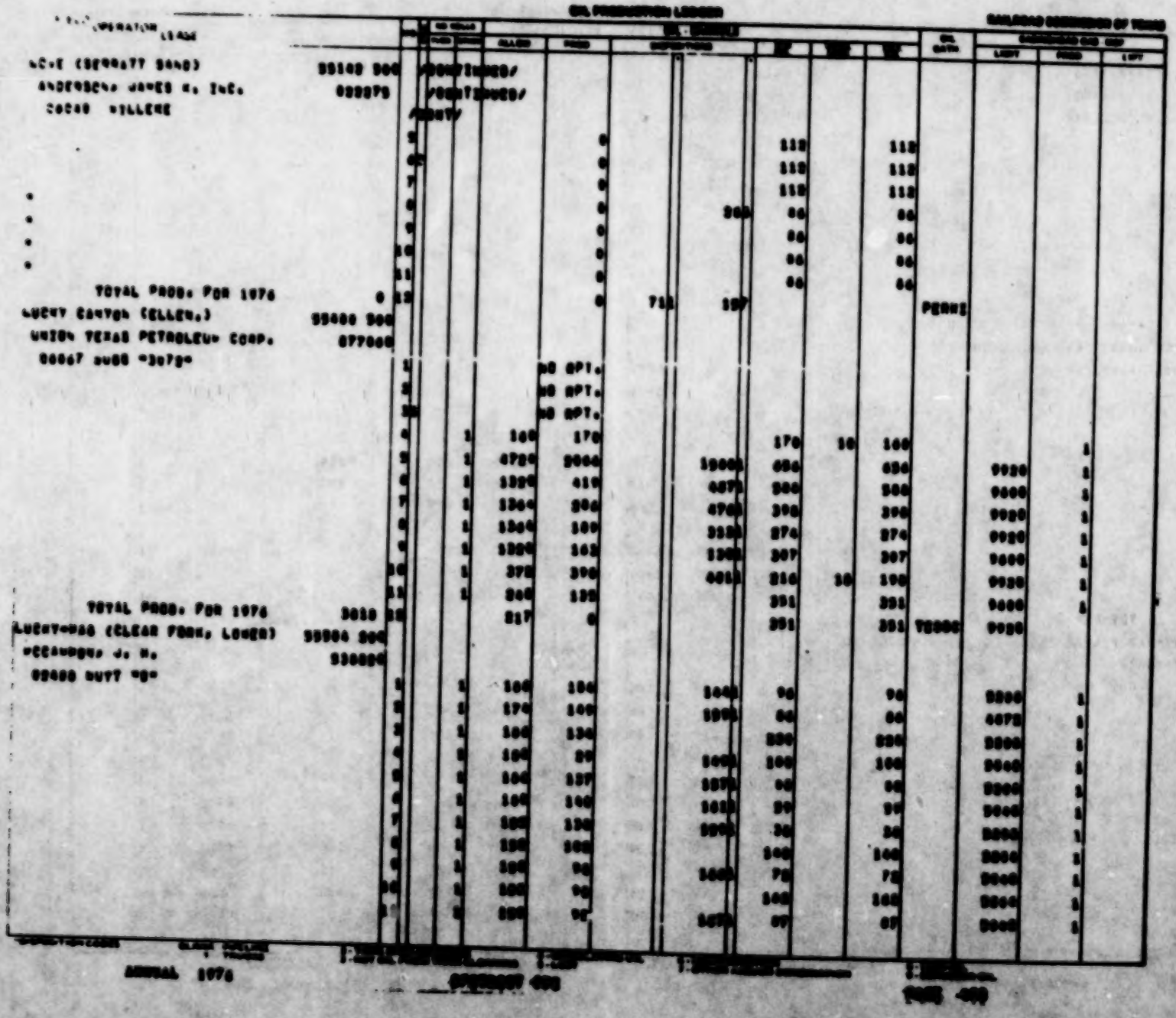
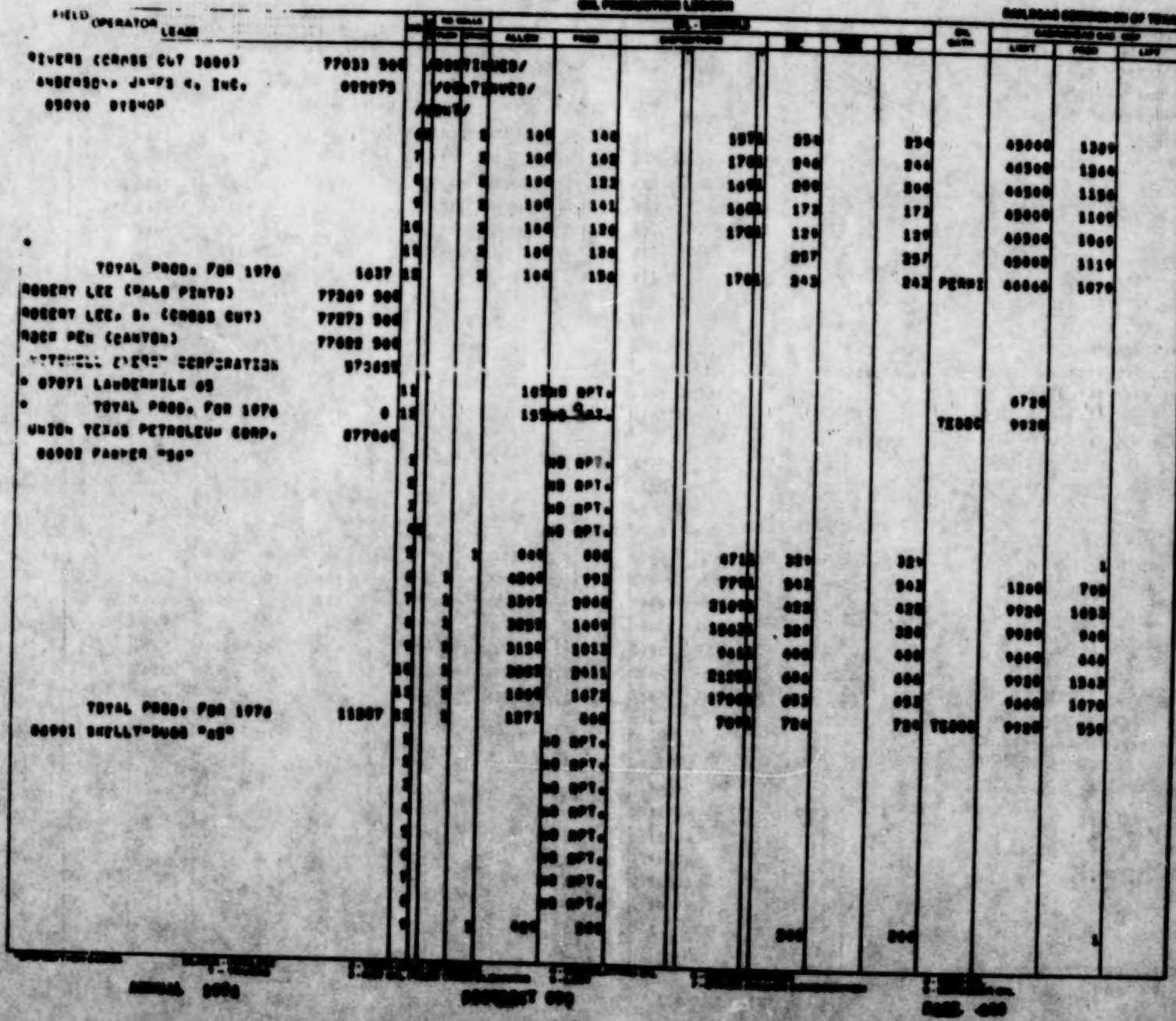
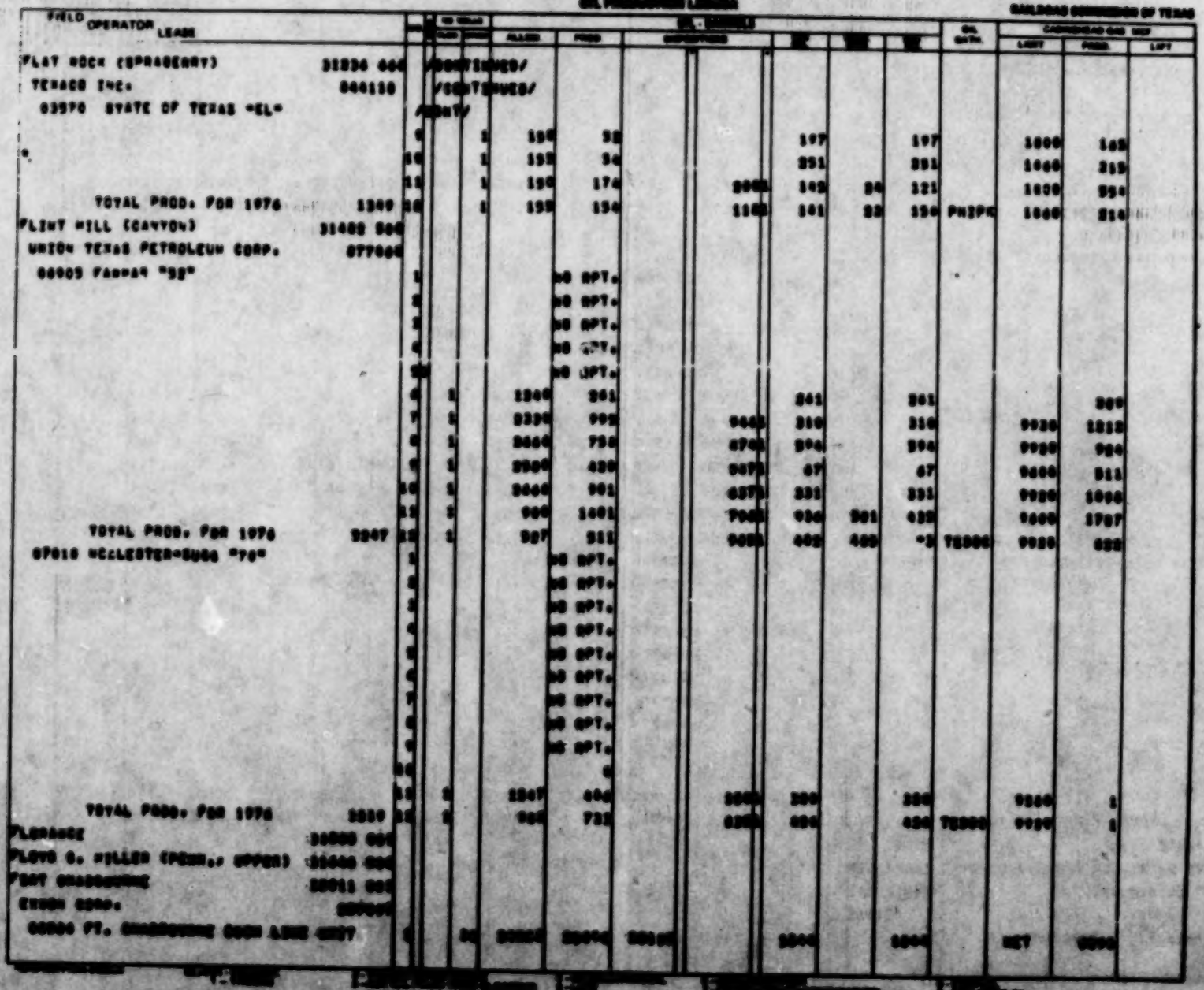
75	1895, E.W. Weygand	654	420	210	210	
76	1896 A. Wiman	657	320	160	160	
77	1897, A. Wiman	658	320	160	160	
78	3044, J. McNeese	466	640	320	320	
79	E. Pt., Sur. 2 D.C. Caldwell	1085	601.8	300.9	300.9	

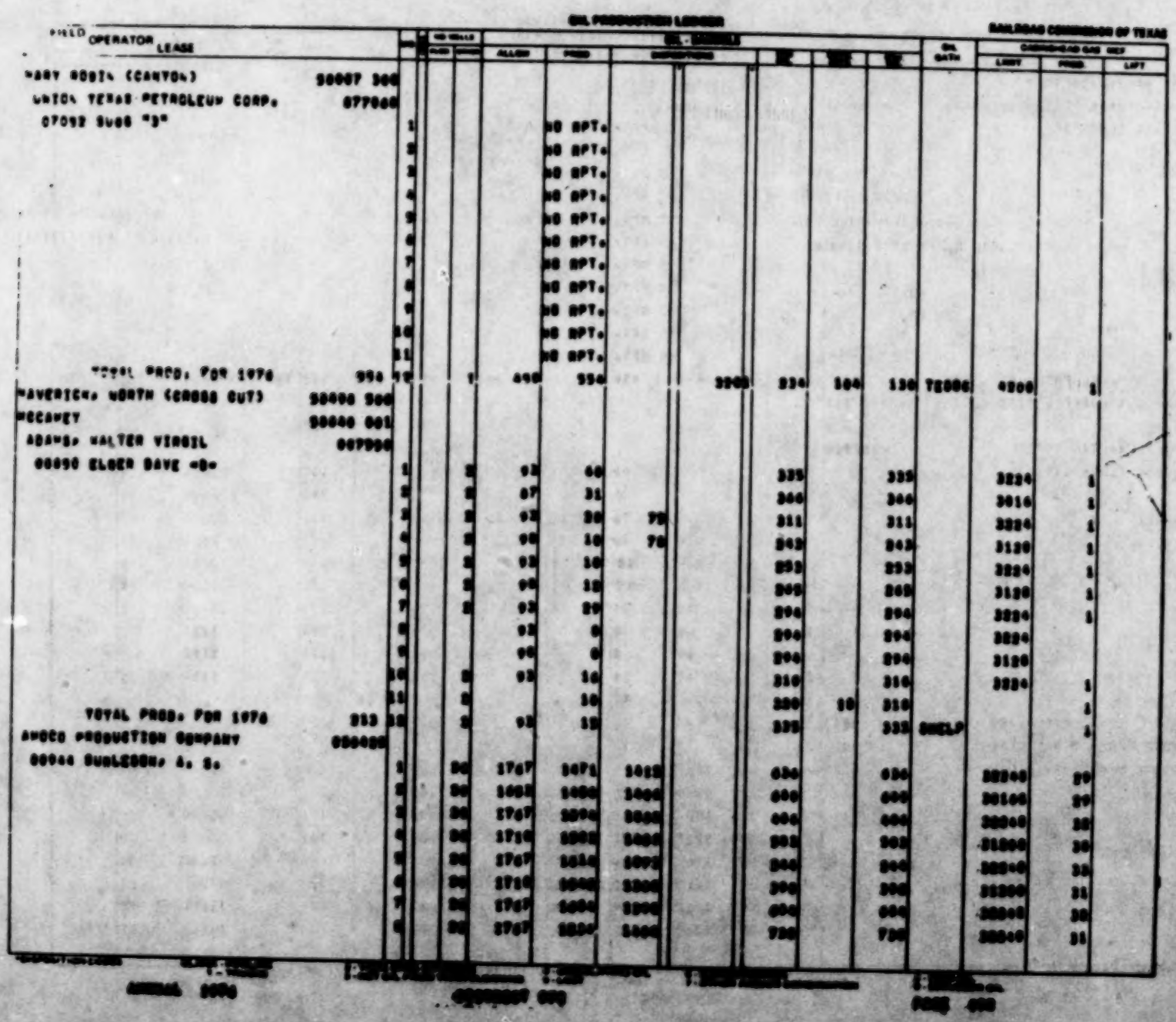
JOINT EXHIBIT K




OIL PRODUCTION LEDGER
RAILROAD COMMISSION OF TEXAS
TOTAL PROD. FOR 1976
LUCKY CANYON (ELLEN.)
UNION TEXAS PETROLEUM CORP.
TOTAL PROD. FOR 1976
LUCKY-ORR (CLEAR FORK, LOWER)
ANNUAL 1976







IN THE UNITED STATES
COURT OF CLAIMS

No. 15-80T

PHILLIP D. FARMER AND MARIAN J. FARMAR, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

No. 16-80T

A. A. SUGG AND MARY S. SUGG, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

AFFIDAVIT OF BOB BALES

THE STATE OF TEXAS
COUNTY OF MIDLAND

BEFORE ME, the undersigned authority, on this day appeared BOB BALES, who, after being duly sworn, did depose and state as follows.

1. I, BOB BALES, am an independent landman actively engaged in the acquisition and sale of oil and gas leases in the area of West Texas and Southeast New Mexico known as the Permian Basin. Most of the leases which I acquire are sold to large independent oil companies that do not possess sufficient personnel to establish a prospect to explore for and produce oil and gas. The purpose of this affidavit is to set forth the facts of which I have knowledge relevant to the issue in the above-captioned federal income tax litigation.

2. In my capacity as an independent landman, I acted as a middleman between (a) Phillip D. Farmar and Marian J. Farmar and A. A. Sugg and Mary S. Sugg and (b) Union

Texas Petroleum Corporation in negotiating the oil and gas leases in issue in the above-captioned federal income tax litigation.

3. When negotiating the terms of an oil and gas lease similar to the leases in issue in this litigation, the amount of bonus and the royalty percentage of production will vary. There is a definite interrelationship between bonus and royalty; the bonus may be balanced against the royalty when negotiating the lease. If a greater amount is received as a bonus, the percentage of production received as a royalty can be decreased.

4. In negotiating an oil and gas lease, as an inducement to obtain a lease from a mineral owner, a lessee will increase the royalty and decrease the bonus or decrease the royalty and increase the bonus. Balancing bonus against royalty is considered standard procedure when negotiating an oil and gas lease.

5. I have personal knowledge of the facts contained in this affidavit, am of sound mind, am over twenty-one years of age, am fully competent to make this affidavit and make this affidavit in support of the Cross-Motion of the Plaintiffs for Summary Judgment in this case.

/s/ BOB BALES
BOB BALES

SUBSCRIBED AND SWORN TO before me this 28th day of July, 1981.

/s/ VALERIE A. DOPSON
Notary Public in and for
Midland County, Texas

IN THE UNITED STATES
COURT OF CLAIMS

No. 15-80T

PHILLIP D. FARMAR AND MARIAN J. FARMAR, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

No. 16-80T

A. A. SUGG AND MARY S. SUGG, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

AFFIDAVIT OF JESSE M. CHIPMAN, III

THE STATE OF TEXAS
COUNTY OF TOM GREEN

BEFORE ME, the undersigned authority, on this day appeared JESSE M. CHIPMAN, III, who, after being duly sworn, did depose and state as follows.

1. I, JESSE M. CHIPMAN, III, am an independent landman. I operate as a middleman between companies which desire to acquire oil and gas leases and mineral owners. I have worked as a landman since October 1959, operating primarily in Texas, Arkansas, Louisiana and Mississippi but also in New Mexico, Oklahoma and Kansas. The purpose of this affidavit is to set forth the facts of which I have knowledge relevant to the issue in the above-captioned federal income tax litigation.

2. The three primary variable factors which are significant in negotiating the terms of an oil and gas lease are the amount of bonus, the percentage of oil and gas production

which constitutes the royalty and the length of the primary term of the lease.

3. The amount of the bonus and the royalty percentage are closely related in negotiating the terms of an oil and gas lease. As the amount of the bonus increases, the royalty percentage will decrease, and vice-versa.

4. The interrelationship between bonus and royalty is illustrated by the terms which a certain company recently offered mineral owners in negotiating oil and gas leases in Tom Green County, Texas. In this particular case, a mineral owner was given the option of receiving a bonus of $25 per acre and a one-sixth royalty or a bonus of $35 per acre and one-eighth royalty. In other words, an increase in bonus would result in a decrease in the royalty percentage while a decrease in the bonus would result in an increase in the royalty precentage.

5. I viewed the interrelationship between bonus and royalty when negotiating oil and gas leases covering portions of a single tract of land in Motley County, Texas. Because the two lessors had different monetary needs, a portion of the tract was leased in exchange for a bonus of $15 per acre and a one-sixth royalty while another portion of the tract was leased in exchange for no bonus and a one-fourth royalty. The other terms of the two leases were very similar. As the amount of the bonus increased, the negotiations assured that the royalty percentage would decrease.

6. I have personal knowledge of the facts contained in this affidavit, am of sound mind, am over twenty-one years of age, am fully competent to make this affidavit and make this affidavit in support of the Cross-Motion of the Plaintiffs for Summary Judgment in this case.

/s/ JESSE M. CHIPMAN III
JESSE M. CHIPMAN III

SUBSCRIBED AND SWORN TO before me this 27th day of July, 1981.

PAULETTE PIERCE
Notary Public in and for
Tom Green County, Texas

IN THE UNITED STATES
COURT OF CLAIMS

No. 15-80T

PHILLIP D. FARMAR AND MARIAN J. FARMAR, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

No. 16-80T

A. A. SUGG AND MARY S. SUGG, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

AFFIDAVIT OF DON DOW

THE STATE OF TEXAS
COUNTY OF MIDLAND

BEFORE ME, the undersigned authority, on this day appeared DON DOW, who, after being duly sworn, did depose and state as follows.

1. I, DON DOW, am a district landman for Union Texas Petroleum ("Union Texas") and have held this position since 1969. From 1958 until entering employment with Union Texas, I held the position of landman with Mid-West Oil Corporation. In my position with Union Texas, I am responsible for acquiring oil and gas leases on behalf of Union Texas. The purpose of this affidavit is to set forth the facts of which I have knowledge relevant to the issue in the above-captioned federal income tax litigation.

2. In my capacity as district landman for Union Texas, I am responsible for obtaining oil and gas leases in the Permian Basin, an area encompassing portions of West Texas and the Southeast portion of New Mexico. Union Texas has

acquired oil and gas leases in the Permian Basin covering approximately 260,000 acres.

3. Union Texas, a division of Allied Chemical Corporation at the time the leases in issue in this case were negotiated, was the company that acquired the leases from Sugg and Farmar.

4. When negotiating an oil and gas lease on behalf of Union Texas, such as the leases acquired from Sugg and Farmar, I am authorized to offer a mineral owner a bonus and a percentage royalty in exchange for the execution of an oil and gas lease. The larger the amount of bonus offered by Union Texas to a mineral owner, the greater likelihood that the mineral owner will accept a smaller percentage share of the production as a royalty. The amount of the bonus offered can be used as a bargaining tool to adjust the mineral owner's percentage share of production offered as royalty.

5. When negotiating the terms of an oil or gas lease, Union Texas recognizes the close interrelationship between bonus and royalty. The royalty and bonus are tied together in the initial negotiations of the oil and gas lease. If a landowner is in poor financial condition and has an immediate need for cash, he will be offered a larger bonus and a smaller royalty percentage as an inducement to sign an oil and gas lease. In addition, Union Texas will offer a mineral owner a greater royalty percentage and little or no bonus as an inducement to execute an oil and gas lease.

6. I have personal knowledge of the facts contained in this affadivit, am of sound mind, am over twenty-one years of age, am fully competent to make this affidavit and make this affidavit in support of the Cross-Motion of the Plaintiffs for Summary Judgment in this case.

/s/ DON DOW

DON DOW

SUBSCRIBED AND SWORN TO before me this 28th day of July, 1981.

/s/ VIRGINIA ANN CURTIS

Notary Public in and for
Midland County, Texas

Supreme Court of the United States

No. 82-774

PHILIP D. FARMAR, ET AL., PETITIONERS,

v.

UNITED STATES

ORDER ALLOWING CERTIORARI. Filed January 10, 1983.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Federal Circuit is granted. The case is consolidated with case No. 82-599, *Commisioner of Internal Revenue* v. *Fred L. Engle, et ux.*, and a total of one hour is allocated for oral argument.

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FILED
DEC 7 1982
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No. 82-774

In the Supreme Court of the United States

OCTOBER TERM, 1982

PHILIP D. FARMAR AND MARIAN J. FARMAR AND
A.A. SUGG AND MARY S. SUGG, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
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In the Supreme Court of the United States

OCTOBER TERM, 1982

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PHILIP D. FARMAR AND MARIAN J. FARMAR AND A.A. SUGG AND MARY S. SUGG, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES

Section 613A of the Internal Revenue Code of 1954 (26 U.S.C.) allows a percentage depletion deduction to be computed with respect to the "average daily production of * * * oil * * * and * * * gas." The question presented by the petition is whether petitioners, who assigned oil and gas leases partly in consideration for lease bonuses, are entitled to a deduction for percentage depletion under Section 613A with respect to these bonuses, which are not tied to the production of oil and gas.

The pertinent facts are undisputed and may be summarized as follows: Petitioners are owners of a mineral estate in lands located in Texas (Pet. App. 1a).[1] They leased

[1]Philip D. Farmar, the Farmar children, and A.A. Sugg were the owners of the mineral interest (See Stip. paras. 5, 16, 17). The Farmar children are not parties in this action. Marian J. Farmar and Mary S. Sugg are parties to this suit solely because they filed joint returns with their spouses. For convenience, references to "petitioners" are to Philip D. and Marian Farmar and A.A. and Mary S. Sugg, collectively.

their ownership interests to two companies interested in oil and gas exploration. As compensation for the agreements, they were to receive cash bonuses payable in several yearly installments; they were also to receive royalties as oil and gas were extracted from the land (Pet. App. 1a-2a). The lease bonuses were payable even if no oil or gas was produced. If the operators abandoned the property, the bonuses were not returnable (Pet. App. 2a n.1).

During 1976, oil and gas were extracted from the property and royalties were paid to the petitioners. The parts of the bonus payments required to be made in 1976 were also made during the year, in the amounts of $528,271.80 to the Suggs and $257,653.90 to the Farmars (Pet. App. 2a; Stip. paras. 11, 24, 25). On their 1976 tax returns, petitioners claimed a 22 percent percentage depletion deduction on both the royalty payments and the lease bonus payments (Pet. App. 2a). The Commissioner of Internal Revenue disallowed the percentage depletion deductions taken with respect to the bonuses.[2] Petitioners paid the resulting deficiencies, and subsequently filed this consolidated suit for refund in the Court of Claims (Pet. App. 1a-2a).

The Court of Claims agreed with the Commissioner that petitioners were not entitled to the percentage depletion deduction with respect to the bonus payments received (Pet. App. 16a). After examining Section 613A of the Internal Revenue Code of 1954, the court stated that "[t]his statutory language regularly linking depletion directly to production during a taxable year indicates to us that Congress wanted depletion to be allowable only 'with respect to' income derived from, or connected with, actual extraction

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[2]There is no controversy as to whether petitioners were entitled to a percentage depletion deduction with respect to the royalties paid during 1976 (Pet. App. 2a n.2).

during the taxable year" (Pet. App. 8a). The court concluded that petitioners "have not met the burden of showing that they are entitled to a deduction under §613A—they have not convinced us that the statute omits the requirement of a direct link to actual production for oil and gas income to be subject to the percentage depletion allowance" (Pet. App. 16a).

DISCUSSION

The decision below correctly held that petitioners were not entitled to a percentage depletion deduction for lease bonus payments.

Prior to the enactment of the Tax Reduction Act of 1975, which added Section 613A of the Internal Revenue Code, the lessor of a mineral interest in consideration for a bonus or advance royalty was entitled to a percentage depletion allowance against such payments, whether or not there was mineral production in the year of payment. *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). But the Tax Reduction Act of 1975 changed the law. It generally repealed the percentage depletion allowance for oil and gas, effective January 1, 1975. See Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 501(a) and (b)(1), 89 Stat. 47 and 53. Congress permitted a single exception to this repeal for independent domestic producers and royalty owners. Thus, Section 613A(c) of the Code provides that percentage depletion "shall be computed in accordance with section 613 [allowing percentage depletion] with respect to * * * so much of the taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed a specified depletable quantity. Section 613A(c)(1)(A) and (B). The "average daily production" is determined by dividing the aggregate production by the number of days in the taxable year.

The Court of Claims correctly interpreted Section 613A to limit receipts eligible for percentage depletion deductions to amounts received with respect to actual production. As the court pointed out (Pet. App. 9a), the lease bonus in this case was not tied to actual production, but only to the parties' expectation of production. The statutory language of Section 613A demands a connection with actual, not expected, production (Pet. App. 9a). Because the lease bonuses at issue here are not based on the actual production of oil and gas, percentage depletion should be denied.

For the reasons more fully set forth in our petition for a writ of certiorari (No. 82-599) in *Engle* v. *Commissioner*, 677 F. 2d 594 (7th Cir. 1982) (Pet. App. 17a-31a), which is currently pending before the Court, we agree with petitioners that the decision below conflicts with that case. In *Engle*, the Seventh Circuit held that taxpayers were entitled to percentage depletion deduction for advance royalties which they received during a year in which there was no production of oil or gas. Contrary to the Court of Claims' statement (see Pet. App. 16a), advance royalties and lease bonuses have been treated alike for tax purposes. See, e.g., *Douglas* v. *Commissioner*, 322 U.S. 275, 280 (1944); *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934).

We therefore believe that it would be helpful to the Court to consider Section 613A in the context of both the lease bonus in the instant case and the advance royalty payment in *Engle*. We therefore do not oppose the petition in this case. The Court may wish to consolidate this case with *Engle* (No. 82-599).

It is therefore respectfully submitted that the petition for a writ of certiorari should be granted.

REX E. LEE
Solicitor General

DECEMBER 1982

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No. 82-774

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

PHILIP D. FARMAR AND MARIAN J. FARMAR
AND
A. A. SUGG AND MARY S. SUGG,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the
United States Court of Appeals
For the Federal Circuit
(Formerly the United States Court of Claims)

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

Under prior decisions of this Court, Section 613(a) of the Internal Revenue Code of 1954 (26 U.S.C.) allows a percentage depletion deduction on oil and gas lease bonuses.

The question presented is whether Section 613A of such Code, enacted by Congress in 1975, by placing a limit on such depletion deduction overturns, *sub silentio*, the prior decisions of this Court so as to eliminate entirely percentage depletion on such bonuses, even though there was oil and gas production from the leases in the year of receipt of the bonuses.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-774

PHILIP D. FARMAR AND MARIAN J. FARMAR
AND
A. A. SUGG AND MARY S. SUGG,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT
(FORMERLY THE UNITED STATES COURT OF CLAIMS)

BRIEF FOR PETITIONERS

STATEMENT[1]

The Petitioners agree with the Statement of this case (No. 82-774) in the Government's Brief (Gov't Br. 3-9) with the following additional evidence which was not mentioned, but which has never been challenged, by the Government in the Argument of its Brief:

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[1] Pursuant to Rule 34.2 of the Rules of this Court, the Petitioners have not included items (d), (e) and (f) of Rule 34.1, relating to the Opinion Below, the Jurisdiction of this Court, and the Statutes Involved, respectively, inasmuch as the Petitioners do not disagree with the presentation of such items by the Government (Gov't Br. 1-3). The Question Presented is stated differently.

1. During 1976, the year at issue, oil and gas was discovered in six wells on the leased property (Stip. para. 31, J.A. 10). These six wells in 1976 produced approximately 25,855 barrels of oil and 13,498,000 cubic feet of gas as shown in the production ledger maintained by the Railroad Commission of the State of Texas (Stip. Exhibit K, J.A. 42-46).

2. All of the evidence (the affidavits of the experts, J.A. 47-52) demonstrate that there is an inverse relationship between the amount of a lease bonus and the royalty percentage; as one increases, the other decreases.

SUMMARY OF ARGUMENT

In a series of cases in the 1930's, this Court worked out a comprehensive set of rules for the federal income taxation of a bonus granted in consideration of an oil and gas lease. These holdings were:

1. A bonus payment was an advance royalty paid to the lessor.
2. Since the bonus was a royalty, the lessor was entitled to the greater of cost depletion or percentage depletion, but if production from the lease was not obtained, such depletion deduction had to be restored to income on the termination of the lease.

In 1975, Congress amended the Internal Revenue Code of 1954 (26 U.S.C.) (hereinafter the "Code") by restricting percentage depletion for oil and gas; it retained such depletion for those taxpayers defined as independent producers and royalty owners.[1] This amendment did not mention any change in this Court's rationale as to bonus income for the defined taxpayers. By inference, however, in the same manner as was rejected by this Court in *Herring* v. *Commissioner*, 293 U.S. 322 (1934), the Government would refuse percentage depletion because of

[1] The Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), 501(b), 89 Stat. 26, 26 U.S.C. § 613(d) (1976) (hereinafter the "1975 Act").

such amendment. The Government's position again is wrong because in the context of this Court's opinions, the language of the Code as amended requires continuation of such depletion allowance. Viewing the resulting statutory arrangement in its basic form, each relevant section of the Code has a distinct function: Section 611 is the enabling provision, granting an allowance for depletion; Section 613 is the definitional provision, offering percentage depletion as one of two alternative methods available for computing the allowance (Section 612 offers cost depletion as the other alternative); and Section 613A (the 1975 amendment to the Code) is the volume limitation — that is, the limiting provision which imposes a restriction on the availability of the percentage depletion alternative set forth in Section 613.

The Government claims that the references to "production" in the amendment mean that there must be production from the lease because the amount of the production is necessary to calculate percentage depletion. This is true, but it does not mean that the production must be concurrent with or prior to the bonus. The production can be later but the depletion allowance is still calculated by applying this Court's rationale. The only difference now is that such calculation must take into account the limitation imposed by the 1975 Act. The limitation is applied over the life of the lease in a manner consistent with the principles of this Court's decisions and the Treasury Regulations.

The legislative history of the amendment is scant, but what history there is supports the Petitioner's position here.

In the alternative, since the Petitioners had actual extraction during the year in question, 1976, Petitioners therefore come within the Government's interpretation of the 1975 amendment. The oil and gas attributable to the Petitioners' royalty were sold in 1976 in the normal course of the oil and gas business, but the Petitioners, in addition to receiving the normal proceeds from the produced minerals, also received payments from the lease,

i.e., the bonus. There is no requirement in the statute that the depletable amount be by reference to the regular sales proceeds. The bonus payments by the lessee in 1976 were just as much payments with respect to production because if those payments had not been made, there would have been no production. As the Circuit Court said in the companion case here, *Engle* v. *Commissioner*, 677 F.2d 594, 600 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 722 (1983), even the production of one barrel of oil would have been sufficient, and Petitioners had much more than that minimum.

ARGUMENT

This Court held in *Herring* v. *Commissioner*, 293 U.S. 322 (1934), that a taxpayer who receives a bonus for the execution of an oil and gas lease is entitled to percentage depletion on the amount of that bonus. The sole question in the present case is whether Congress in 1975, *sub silentio*, by some vaguely perceived penumbra of newly enacted Section 613A, changed that result. To answer that question, one must examine: (i) *Herring* and related cases and (ii) Section 613A, the pertinent 1975 amendment to the Code.

The Supreme Court's Repeated Examination of the Lease Bonus Allowed Percentage Depletion Thereon — The *Herring* Case, Its Ancestor and Progeny

An oil and gas lease bonus is an amount of money given by a lessee to a lessor as the consideration for the execution of an oil and gas lease. This money is viewed as the proceeds of the sale of an interest in realty for purposes of most state property laws; but in *Burnet* v. *Harmel*, 287 U.S. 103 (1932), this Court concluded that for federal income tax purposes the lessee's bonus payment was not for the sale of property rights, but instead was an advance royalty paid to the lessor.[3] Hence, the income tax

[3] This was later amplified in *Anderson* v. *Helvering*, 310 U.S. 404, 409 (1940): "Cash bonus payments, when included in a royalty

character of the payment was ordinary income instead of capital gain.

Two years later, in *Herring* v. *Commissioner*, 293 U.S. 322 (1934), this Court extrapolated from *Harmel*, by holding that since the bonus was in the nature of an advance royalty, the depletion tax treatment should be identical to that of a royalty paid with respect to actual production; thus, the greater of cost depletion or percentage depletion deduction was allowable on the bonus.[4] This principle was applicable even if no wells were drilled during the year of the receipt of the bonus and no oil or gas was extracted during such year. This Court held that (1) Congress intended to allow depletion on all royalties, including bonuses, because a bonus is "payment in advance for oil and gas to be extracted. . . . As such it is a part of the 'gross income from the property' . . . to designate the base for the application of percentage deduction," *id.* at 324, and (2) if depletion is to be allowed at all, it must be claimed in the year the bonus is paid.[5]

A decade later, this Court in *Douglas* v. *Commissioner*, 322 U.S. 275, 285 (1944), held that the depletion on an advance royalty[6] is only tentatively allowed subject to the contingency that actual extraction will occur, and "that if the contingency

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lease, are regarded as advance royalties, and are given the same tax consequences."

[4] This principle is incorporated in Treas. Reg. § 1.611-1(a)(1) (1982).

[5] The resemblance of the Government's position there to that advanced by the Government in the instant case is startling. In *Herring* v. *Commissioner*, 293 U.S. at 325-26, the Commissioner also relied on his own opinion (G. C. M. 11384, XII-1 C.B. 64 (1933)) and urged that since the pertinent section of the 1926 Act provided an allowance for depletion "in the case of ... oil and gas wells," this language excluded situations where no such well existed.

[6] While the Court of Claims in the instant case in an aside posited a question as to whether there is a difference in result between an advance royalty and a bonus, it is believed that no court for federal tax purposes ever has reached such a result and none is urged here by either the Petitioners or the Government.

failed, the suspended sums should fall into income in the year that the failure was manifested by the termination of the lease."

In summary, depletion deductions of oil and gas bonuses are, and always have been, inextricably entwined with the actual extraction or production of oil or gas. [7] Since (1) the bonus is paid in advance of extraction, (2) the claim of right doctrine requires the recognition of the income at the time of receipt [8] and (3) depletion deductions must also be claimed in the same year the income is realized for proper matching, this Court made the tax results compatible with the economic reality. If actual extraction of oil or gas occurred, the bonus was accorded the same tax treatment as any other royalty. If oil or gas extraction did not occur, there could be no royalty and the bonus was treated as ordinary income without depletion. Since the oil or gas extraction results were unknown at the time of the bonus payment, the percentage depletion was allowed tentatively and was subject to being restored to taxable income if no extraction occurred.

A lessor's depletion deduction, however, has never existed in a vacuum; rather, it has always been interdependent with the amount of depletion deductions allowable to the lessee. In *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312 (1934), this Court held that there was a single depletion deduction for any particular oil and gas property, and that this deduction must be apportioned between the lessor and lessee. When a lessor, therefore, claims percentage depletion on a bonus, the lessee must reduce his percentage depletion by exactly the same amount. This is the "bonus exhaustion" rule:

> [I]f the percentage depletion is allowable upon the cash bonus . . . received by the lessor, such bonus must be deducted from the gross income from production received by the lessee in computing depletion; otherwise double

[7] The Government agrees (Gov't Br. 15).

[8] *North American Oil Consol.* v. *Burnet*, 286 U.S. 417 (1932).

percentage depletion deductions would result contrary to the statute.[9]

Thus, considering both the lessor and the lessee, the cycle was complete and by 1944 this Court had established an entire system for the taxation of oil and gas bonuses.

A. THE STATUTORY CONSTRUCTION OF THE 1975 ACT REQUIRES CONTINUED ACCEPTANCE OF THE *HERRING* RULE

The applicable depletion sections of the Code remained unchanged until 1975. In that year, Congress enacted Section 613A of the Code as part of the 1975 Act. The Government contends that this new provision, by merely placing a limit on the amount of each independent producer's and royalty owner's percentage depletion, *sub silentio*, without any apparent consideration, abolished for such producers and royalty owners the entire system of leasehold bonus taxation meticulously established by this Court. The answer to this contention is found in an examination of Section 613A.

1. The Cross References

When in 1975, Congress enacted Section 613A to provide limitations upon the depletion allowance, it retained percentage depletion for a portion of the oil and gas production of independent producers and royalty owners. In a tangled web of cross references,[10] Section 613(d) of the Code, enacted at the

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[9] *Quintana Petroleum Co.* v. *Commissioner*, 143 F.2d 588, 591 (5th Cir. 1944). The bonus exhaustion rule is also found in Treas. Reg. § 1.613-2(c)(5)(ii) (1982) and accompanying examples.

[10] This legislation has been called a "drafting nightmare," a "mangled statute." *Commissioner* v. *Engle*, 76 T.C. 915, 928 (1981), *rev'd*, 677 F.2d 594 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 722 (1983) (Goffe, J., concurring).

One cannot help repeating the oft-cited comment of Judge Learned Hand:

> [T]he words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession: cross-reference to

same time as Section 613A, specifically provided that: "[e]xcept as provided in section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section." Section 613A(a) of the Code adopted reciprocal language by providing that "[e]xcept as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613." The exception referred to in Section 613A(a) is found in a further cross reference; Section 613A(c)(1) states that "the allowance for depletion under section 611 shall be computed in accordance with section 613" with respect to a certain amount of each independent producer's and royalty owner's crude oil and gas production.

2. The Roles of the Separate Sections

It is significant that the volume limitation was added by the Act in the form of new Code Section 613A rather than through an amendment to the existing Section 613. Viewing the resulting statutory arrangement in its basic form, each section has a distinct function: Section 611 is the enabling provision, granting an allowance for depletion; Section 613 is the definitional provision, offering percentage depletion as one of two alternative methods available for computing the allowance (Section 612 offers cost depletion as the other alternative); and Section 613A is the volume limitation — that is, the limiting provision which states a restriction on the availability of the percentage depletion alternative set forth in Section 613.

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cross-reference, exception upon exception — couched in abstract terms that offer no handle to seize hold of — leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.

Hand, *Thomas Walter Swan*, YALE L.J. 167, 169 (1947).

This Court has often recognized the importance of respecting the separate functions of sections of the Internal Revenue Code for purposes of construing a statute. For example, in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 319 (1934), this Court observed that Section 234(a)(8) of the Revenue Act of 1926 — the textual predecessor of Section 611 of the Code — is the "granting" provision, and Section 204(c)(2) of the Revenue Act of 1926 — the textual predecessor of Section 613 of the Code — is the provision providing "the method of computation." The functional differences in these provisions has persisted; the addition of Section 613A only adds another functional level to the network of depletion sections, each of which must necessarily be interpreted as an independent member of a group of provisions related only to the extent they bear on the ultimate allowance for depletion.

The functional independence of Section 613 and Section 613A is demonstrated by the different bases employed in achieving the separate purpose of each. Section 613(a) provides that the depletion allowance for an eligible taxpayer is equal to a percentage of *gross income* from the property, whereas Section 613A(c) establishes the eligibility of the taxpayer (i.e., "exempt" from the general repeal of percentage depletion set forth in Section 613A) to the extent of a certain *physical volume* of oil and gas production each day. "Gross income" in Section 613 is the basis to which the applicable percentage is applied for purposes of computation of the allowance; "production" in Section 613A is the basis to which the applicable depletable oil quantity is compared for purposes of determining the extent to which a particular taxpayer is eligible for the allowance as computed. The Government and the Court of Claims have simply confused the functions of the two sections and thus the plain meaning of the language *used in the context of each particular section.*[11]

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[11] The Government's massive confusion on this point can be clearly seen at p. 23 of the Government's Brief where it is stated that "zero

3. "With Respect to" Production

The substance of the Government's view (Gov't Br. 10-11), as well as that of the Court of Claims (Pet. App. 7a-8a), is that the use of the term "production" in Section 613A requires, in effect, that percentage depletion be with respect to payments that are, in turn, with respect to extraction during the same year.[12] This is an incorrect reading of the statute; there is nothing in it to impose such requirement. Section 613A only requires that the depletion deduction itself (not the payment making up the depletable gross income) be with respect to a given level of production.[13]

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production times the applicable percentage depletion rate (22%) equals zero." In the statutory method, 22% is never multiplied by barrels of production, but instead is *always multiplied times the dollars of income.*

[12] The Government repeatedly has attempted to bootstrap its position by citation (Gov't Br. 20, 21, 24) of some commentators as supporting its position. It is interesting to review some of the later writers who have looked at the current problem in detail, particularly in light of Judge Fay's comments in dissent in *Commissioner* v *Engle*, 76 T.C. at 961 n.3. For example: ARTHUR ANDERSEN & CO., OIL & GAS FEDERAL INCOME TAX MANUAL 156 (11th ed. 1982); A. BRUEN & W. TAYLOR, FEDERAL INCOME TAXATION OF OIL AND GAS INVESTMENTS, § 7.09[2] (1980); Backus, *A Stitch in Time Necessary to Save Lease Bonus Depletion*, 56 TAXES 313 (May, 1977); Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction*, 57 J. OF TAX. 230 (October, 1982); Note, *Taxation — Percentage Depletion Not Available with Regard to Advance Royalties Received on Non-Producing Oil and Gas Lease*, 56 TULANE L. REV. 1082 (1982). All of these commentators, who are the only ones who examine the issue in any depth, either question the position of the Government here or oppose it.

[13] The Government cites Bravenac, *Continued Availability of Percentage Depletion of Oil and Gas*, 23 OIL & GAS TAX Q. 204 (1975), for the proposition that "there is no basis for the court's construction in *Engle* ... that Section 613A turns on sales or income received instead of production" (Gov't Br. 20-21). It is astounding that the Government failed to note that this commentator's conclusions are quite contrary to the Government's arguments and that Bravenac takes a position soundly in favor of Petitioners' position.

Even under Section 613 alone (i.e., prior to 1975) this Court and the Treasury Regulations required that the depletion deduction be "with respect to" production. When gross income and production were coterminous, the depletion was "with respect to" *current* production. As this Court stated in *Helvering* v. *Bankline Oil Company*, 303 U.S. 362, 366 (1938):

> [The depletion allowance] is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production.

But in the case of bonus payments (again, under Section 613 alone and prior to 1975) gross income qualifying for percentage depletion always was required to be "with respect to" *future* production from the property prior to cancellation of the lease. As this Court stated in the *Douglas* case, 322 U.S. at 284:

> The taxpayer who receives advance royalties receives a gross income but has no statutory right to depletion apart from *actual or prospective extraction.* To grant irrevocable depletion in circumstances where cancellation of the lease

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Bravenac sees three possible ways to construe Section 613A: (1) that percentage depletion is henceforth to be allowed at the time (and on the amount of the value) of oil and gas production irrespective of the time of receipt (and amount) of gross income, (2) that "production" actually means "sales" and, therefore, percentage depletion should continue to be based upon gross income from the property, and (3) that the computation of percentage depletion will continue to be based upon gross income from the property but that "production" as used in Section 613A means "that percentage depletion will be limited to an amount based on production." *Id.* at 211-12.

Bravenac highly favors alternative (2), which is closest to Petitioners' position here. In fact, Bravenac states, "[T]hus, the construction of 'production' as sales for all purposes under Section 613A(c) is highly desirable." *Id.* at 212. When alternative (2) is applied to bonuses, Bravenac recognizes the practical difficulties of imposing the Section 613A limitation, but states that the difficulty "is capable of solution." *Id.* at 213. Bravenac then suggests a possible solution quite similar to that advanced by Petitioners here. *Id.* at 213 n.22.

> occurs prior to extraction would sever depletion from extraction.

(Emphasis added.)

Since Congress is presumed to enact new legislation with the knowledge of how previous statutes have been interpreted, [14] it is only logical to conclude that when Congress requires percentage depletion to be "with respect to" production in Section 613A, Congress intends the term "production" to have the same meaning as previously applied — *current* production for coterminous gross income and *future* production for bonus income. Of course the "production" requirement of Section 613A adds a precise volumetric limit, whereas the "production" requirement of Section 613 is more general, but otherwise the terms should have identical meanings. This can be summarized: (1) this Court imposed a requirement that the depletion deduction under Section 613 be with respect to production; (2) in the case of bonus income, that requirement meant *future* production; (3) Congress enacted Section 613A with the knowledge of such interpretation; and (4) the production requirement of Section 613A should be interpreted in an identically parallel manner as the production requirement of Section 613 — that bonus income must be with respect to *future* production from the leased property.

4. Correlation of Sections 613 and 613A

Much has been made as to the difficulties if one calculates percentage depletion upon income (as mandated by Section 613) while using limitations based upon physical production of barrels of oil and cubic feet of gas (as required by Section 613A) [15] — as

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[14] *See Lorillard* v. *Pons*, 434 U.S. 575, 581 (1978).

[15] See the lamentations in *Engle*, 76 T.C. 915, 926 (1981) and in the concurrence of Judge Goffe at pp. 926-40 and in the dissent of Judge Fay at pp. 942-48. *Cf.* Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction [sic]*, 57 J. OF TAX. 230, 233 (October, 1982); and Note, *Taxation Percentage*

if such perceived difficulties are a reason not to follow the prior decisions of this Court. These difficulties are avoided if Section 613 and Section 613A are harmonized and reconciled logically. As might be expected, the compatability of these two statutory provisions can be derived from the rationale of *Harmel*, *Herring* and *Douglas*.[16]

As the evidence in the instant case demonstrates, [17] the bonus for an oil and gas lease is interdependent with the royalty retained by the lessor upon execution of the lease. A smaller bonus will command a higher royalty; completely eliminating the bonus will command the highest royalty obtainable. It is thus apparent that the bonus is in fact a replacement for, and is interchangeable with, a certain fraction of additional royalty which is economically equivalent to the bonus. Since economic equivalency exists in the arms-length negotiations of the parties, the federal income tax consequences of a bonus and a royalty also should be equivalent. Otherwise, there is an economic imbalance which this Court avoided in *Herring*.

In this economic setting, *viewing a bonus as an additional royalty (as this Court consistently has done) is the key to harmonizing Section 613 and Section 613A*. As emphasized above, Section 613 requires that the calculation of percentage depletion be based upon dollars, not on barrels of oil or cubic feet of gas extracted. However, Section 613A sets a limit on oil

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Depletion Not Available With Regard to Advance Royalties Received on Non Producing Oil and Gas Lease, 56 TULANE L. REV. 1082, 1101 (1982). As stated in such Note at 1102: "If a workable solution is available, then the *Herring* precedent and the underlying theories of depletion deduction should militate toward the adoption of such an interpretation of the statute [*i.e.*, for percentage depletion on the bonus]." The Note at 1102-04 then accepts the solution in the dissent of Judge Fay.

[16] *See* pp. 4-7, *supra*.

[17] *See* J.A. 47-52.

and gas percentage depletion based upon barrels of oil and cubic feet of gas extracted. These two concepts are harmonized by:

(1) applying Section 613 to the bonus; and

(2) applying Section 613A to the slice of additional royalty to which the bonus is equivalent.

Under this method, a percentage depletion deduction is allowable on the bonus in the year such bonus is received, irrespective of whether extraction occurs in that year. The bonus dollars then are converted into the slice of royalty which those dollars represent and are allocated over the life of the same oil and gas property in exactly the same manner as the lessor must allocate his basis in such property for calculating his cost depletion.[18] With a certain amount of bonus dollars thus allocated to each unit of the future production during the life of the lease, when oil or gas is extracted and sold those bonus dollars are converted into their equivalent of barrels of oil or cubic feet of gas, depending upon which product is actually produced and sold. The conversion from dollars to barrels or cubic feet is accomplished by applying the actual sale price realized for the products. The bonus barrels of oil are then counted in the lessor's 1000 barrel per day limit along with the barrels of oil resulting from actual extraction during that year. The same method is applied to gas production.

In the event that the taxpayer's actual production plus imputed production from the bonus exceeds the barrel limit, the portion of the percentage depletion deduction taken in the previous year on the portion of the bonus allocable to the year in question (and in excess of the limit) must be restored to income just as the principles of *Douglas* and Treas. Reg. § 1.613-3(a)

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[18] *Cf.* Treas. Reg. § 1.612-3(a) (1982). This rationale is suggested in the widely-accepted text of ARTHUR ANDERSEN & CO., OIL & GAS FEDERAL INCOME TAX MANUEL 154 (11th ed. 1982); *see also* Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction [sic]*, 57 J. of Tax. 230, 233 (October, 1982).

(1982) have required (and still require) in the event that there is not production prior to expiration of the lease. The validity of this proposition can be illustrated by an example[19] which, unfortunately must be almost as complex as the examples in the pro-

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[19] For example, a bonus of $300,000 is paid in year 1 and equal amounts of production are expected in years 2, 3 and 4. While the lessor realizes $300,000 of depletable income in year 1, for purposes of the limitation in Section 613A the lessor should treat the $300,000 bonus as though he received an additional royalty of $100,000 in each of years 2, 3 and 4. This spreading is feasible because it requires only that the lessor estimate his reserves as he must do for purposes of his cost depletion in any event. He need not estimate his reserves prior to the commencement of production because no spreading need occur until there is production.

Further, assume in year 2 the lessor receives $200,000 in royalties representing 5,000 barrels of oil sold at an average price of $40 per barrel. Again, because the lease reserve estimates (for purposes of cost depletion) indicate that oil extraction will remain constant for three years and then cease, one-third or $100,000 of the bonus should be deemed received in year 2. This $100,000 represents an additional 2,500 imputed barrels (approximately 7 imputed barrels per day) resulting in total production for the year of 7,500 barrels of oil, or approximately 20 barrels per day, which is well below the 1,000 barrel per day limit of Section 613A(c). Thus, it has now been established that at least one-third of the depletion allowance taken on the bonus was justified. The levels of production (from this and other wells of the taxpayer) will determine in years 3 and 4 whether the other two-thirds was justified.

Alternatively, assume the taxpayer has an average daily production of 1080 barrels from other leases in year 2 in addition to the 20 barrels per day for the well under discussion. The applicable barrel limit under Section 613A(c) is 1,000 barrels. The 1080 barrels from the other wells plus 20 barrels from this well produces 1,100 barrels or 100 barrels of excess production. Prop. Treas. Reg. § 1.613A(d)(1977) requires that when a taxpayer's depletable oil quantity exceeds 1,000 barrels per day, the production from each property is reduced proportionately to determine the amount of qualified production. In this case, one-eleventh (100 divided by 1,100) of oil production is disqualified; thus, one-eleventh of his royalty is disqualified. Now for the first time it is known that a portion of the percentage depletion deduction on the bonus must be restored to income (just as would be required if no production occurred). Therefore, one-eleventh of the percentage depletion deduction taken on the $100,000 portion of the bonus allocated to year 2 must be restored to income.

posed Treasury Regulations.[20] In this manner, the volume limitation is added to the depletion framework with a minimum compliance burden on the taxpayer. Moreover, the percentage depletion limitation of Section 613A is accomplished without doing violence to either the separate statutory roles of "gross income" and "production" or well-settled judicial principles regarding the theory of depletion.[21]

B. SETTLED RULES OF STATUTORY INTERPRETATION PRECLUDE A CONSTRUCTION OF THE 1975 ACT THAT OVERTURNS *HERRING*

The *Herring* Court, as discussed above, held[22] that there is no "logical justification" for requiring that production be a prerequisite to the allowance for percentage depletion inasmuch as it is a blatant inconsistency to allow a cost depletion deduction with respect to a lease bonus but to deny a percentage depletion deduction for such income. The identical nature of cost and percentage depletion long-recognized by this Court requires, if at all possible, that the two methods of computing depletion be applied consistently. Nevertheless, the Government, as it did in *Herring*, again asserts that such inconsistency must be the intent of Congress.

Congress should not be presumed to have made such a change, overturning many decisions of this Court in the law of depletion, without "some more explicit expression of its purpose" for "[i]f Congress had wanted to modify that [existing] practice, it could readily have done so by specific provision." *Mastro Plastics Corp.* v. *NLRB*, 350 U.S. 270, 289 (1956).[23]

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[20] *See* Prop. Treas. Reg. § 1.613A-4(a)(2) (1977).

[21] The importance of respecting the separate functions of Section 613 and Section 613A is discussed at pp. 8-9, *supra*.

[22] 293 U.S. at 328.

[23] In 1932 Congress changed the definition of "gross income" solely for the purpose of computing the percentage depletion deduction by amending what is now Section 613 of the Code to read: "In the case

This Court in *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 467 (1933) observed that:

> There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not and that depletion included under the 1926 Act precisely what it included under the earlier Acts.

So it is here. Congress clearly provided a limitation on eligibility for depletion, but there is no indication it intended that once eligibility was established, depletion meant something different than this Court had worked out under the earlier acts.[24]

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of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.*" Revenue Act of 1932, § 114(3), 47 Stat. 169 (1932). (Amendment in italics.)

[24] The Court of Claims has taken the startling position here that *no one* is entitled to a depletion allowance with respect to the portion of the income from the property represented by the bonus (Pet. App. 14a-15a). This conclusion requires two steps, both of which are wrong. First, the Court of Claims accepts the Government's contention that the lessor is denied depletion under Section 613A. The error of this step is the subject of this case.

The Court of Claims, however, erred a second time in *dictum* in accepting the Government's contention (*see* Rev. Rul. 81-266, 1981-1 C.B. 139 (1981)) that the lessee must nevertheless reduce his depletion allowance by the percentage depletion which (at least prior to 1975) would be allowable to the lessor on the bonus. The court ignored the justification of the "bonus exhaustion rule" as articulated in the *Quintana Oil* case discussed above, which rule was designed to prevent two taxpayers from claiming a depletion allowance on the same income; instead the Court of Claims has twisted the rule to deny *everyone* a depletion allowance on the portion of production income from the property represented by the bonus.

Such result is blantantly inconsistent with the entire theory of depletion established by this Court, for as this Court stated in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. at 321:

C. THE LEGISLATIVE HISTORY OF THE 1975 ACT IS CONSISTENT WITH THE SETTLED TREATMENT OF BONUS INCOME

1. Committee Reports on the 1975 Act

The lower courts have acknowledged that there was no floor debate or discussion in the committee reports on the continued availability of the depletion allowance with respect to bonus income (Pet. App. 11a, 27a, 43a). While this is true, the only pertinent language in the legislative history of the 1975 Act is helpful to Petitioner's position here. In the Conference Report on the 1975 Act it is stated:

> Under the Senate amendment, the deduction for percentage depletion is generally eliminated with respect to oil and gas produced on or after January 1, 1975, with certain exceptions. These include the exceptions provided in the House bill. In addition, the Senate amendment *retains percentage depletion* at 22 percent on a permanent basis for

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> At all events, . . . the section [the predecessor of Section 613] must be read in the light of the requirement of apportionment of a *single depletion allowance*.... The apportionment gives [the lessee] 27½ per cent. of the gross income from production which it had the right to retain and the [lessors] respectively 27½ per cent. of the royalties they received. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance.
>
> (Emphasis added.)

Therefore, if the Court of Claims was correct in its first step (denying the bonus depletion to the lessor), it erred in its second step in failing to shift the portion of the aggregate amount of depletion from the lessor to the lessee in accordance with the principle of the *Twin Bell* case. However, the very fact that the language in Section 613 which requires such a shift between lessor and lessee was left intact by the 1975 Act demonstrates that Congress did not intend to deny the depletion benefit to the lessor on the bonus. A leading commentator has recognized the Government's inconsistency in denying percentage depletion on bonus income while implementing the "bonus exclusion rule." ARTHUR ANDERSEN & CO., OIL AND GAS FEDERAL INCOME TAX MANUAL 154-56 (11th ed. 1982).

> the small independent producer *to the extent* that his average daily production of oil *does not exceed* 2,000 barrels a day, or his average daily production of gas *does not exceed* 12,000,000 cubic feet. Where the independent producer has both oil and natural gas production, the *exemption* must be allocated between the two types of production.
>
> . . . .
>
> The conference substitute follows the Senate amendment in providing a small producer *exemption* from the repeal of percentage depletion for oil and gas.

H. CONF. REP. NO. 120, 94th Cong., 1st Sess. 67-68 (1975), *reprinted in* 1975-1 C.B. 624, 629-30 (1975) (emphasis added).

Language such as "retains," "exemption," "to the extent" and "does not exceed" used in this passage reflects that the purpose for the independent producer and royalty owner provision was to limit the availability of percentage depletion to a certain volume of oil and gas.[25] As stated before, there is no indication that there was an intent to redefine the classification of gross income used as the basis for computing the allowance.

The Tax Court in *Commissioner* v. *Engle*, 76 T.C. at 923, would dismiss this language by saying the use of "retains" was only referring to a Senate amendment, but it is this Senate amendment that became the law as to percentage depletion for the independent producers and royalty owners.

2. **Committee Reports on the 1974 Bill**

The Court of Claims (Pet. App. 11a-13a) and the Government (Gov't Br. 24-26) both erroneously placed significant weight on the discussion in the House Ways and Means Committee Report relating to a bill introduced in the preceding Congress. H.R. 17488, 93d Cong., 2d Sess. (1974); H.R. REP. NO. 1502, 93d Cong., 2d Sess. 46 (1974). Inasmuch as this bill (and

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[25] For example, the word "retain" is defined in *Webster's Third New International Dictionary* 1938 (unabridged ed. 1969) to mean "continue to have."

its report) was never considered (much less voted upon) by the House, the Senate Finance Committee or the Senate, of either the 93d or the 94th Congress, it is clear error to place any weight on such report.

It is a well-settled principle of statutory construction that the interpretation of a provision in an act should not include the history of bills which were not enacted. *See United States* v. *American Trucking Association*, 310 U.S. 534, 550 (1940) (Court noted irrelevance of pending "unadopted" bill for purposes of statutory construction of Motor Carrier Act).[26] Simply stated, the legislative history of an unenacted bill of another Congress is irrelevant.[27]

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[26] *See also United States* v. *Lincoln Rochester Trust Co.*, 297 F.2d 891, 893 (2d Cir.), *cert. denied*, 369 U.S. 887 (1962) (portions of report discussing language not included in the act as finally adopted may not be relied upon for purposes of interpretation); *Interstate Natural Gas Co.* v. *Federal Power Commission*, 156 F.2d 949, 952 (5th Cir. 1946), *aff'd*, 331 U.S. 682 (1947) ("Certainly the legislative history of a bill that was not adopted cannot be resorted to construe a bill that was"); and *Rugamer* v. *Thompson*, 130 N.J. Super. 181, 325 A.2d 860, 862 (N.J. Super. Ct. Law Div. 1974) ("If a bill covering the same topic never emerges from the committee it has no significant bearing on the matter of statutory construction").

[27] The citation of *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 246, 264 (1945), by the Government (Gov't Br. 27) as authority for using as legislative history a committee report of a prior Congress is entirely misplaced. The *Gemsco* case solely concerned different versions in the respective bodies of bills in the same Congress on the same subject matter that resulted in a reconciliation in a conference committee and an enactment into law by that Congress.

Petitioners do not disagree with Government's citation of *Helvering* v. *Morgan's, Inc.*, 293 U.S. 121, 126 (1934) (Gov't Br. 27) for that point which this Court actually held. Indeed, it is pertinent to the point here made with respect to related sections (*see* p. 8-9, *supra*), but this case provides no support whatsoever for the attempt to use a committee report on a bill never considered by that or any other Congress.

See also NLRB v. *Lion Oil Co.*, 352 U.S. 282, 291 (1957) (1948 Committee Report is "no part of legislative history" of 1947 Act).

The impropriety of placing any significance on the legislative history of a bill other than the 1975 Act is exemplified by the totally divergent paths taken by H.R. 17488 in 1974 and H.R. 2166 in 1975 (H.R. 2166, 94th Cong., 1st Sess. (1975)), the bill which became the 1975 Act. The 1975 bill originated in the House Ways and Means Committee.[28] However, the 1975 bill as reported out of the House committee contained no provisions as to oil and gas percentage depletion (and thus no independent producer and royalty owner exemption). H.R. REP. NO. 19, 94th Cong., 1st Sess. 3 (1975). This is to be contrasted with H.R. 17488 in 1974 which, as reported out of the House committee in the previous Congress, contained a repeal provision for percentage depletion together with an independent producer and royalty owner exemption different from that ultimately enacted as part of the 1975 Act.[29]

The provision in H.R. 2166 in 1975 regarding the repeal of percentage depletion was added on the floor of the House, although this floor amendment did not include any independent producer and royalty owner exemption. 121 CONG. REC. 4651-52 (1975). The independent producer and royalty owner exemption was introduced into H.R. 2166 in 1975 on the floor of the Senate. 121 CONG. REC. 7813 (1975).

Thus as the Seventh Circuit summarized in the *Engle* case, 677 F.2d at 598:

> **We think that the legislative developments in 1974 and 1975 undercut the Commissioner's reliance on statements pertinent to H.R. 17488. In the Committee version of H.R. 2166, the House *retained* the percentage depletion rules as they then existed. This is the opposite position from that taken by the same Committee in H.R. 17488. It is**

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[28] The Government inaccurately refers to H.R. 2166 as the "successor" to H.R. 17488 (Gov't Br. 25).

[29] The Seventh Circuit also noted that the producer exemptions in H.R. 17488 and H.R. 2166 were not identical (Pet. App. 25a).

> extremely difficult, as a matter of common sense, to conclude from this pattern that the intent of the House in 1974 remained unchanged in 1975.

(Emphasis in original.) (Pet. App. 24a-25a.)[30]

3. Congressional Hearings and Debates on 1975 Act

The Government has attempted to use the 1975 congressional hearings and floor debates on H.R. 2166 as support for its argument that percentage depletion on a bonus "must be based on current production" (Gov't Br. 27-29), but the quotations cited do not say that; indeed, if these statements mean anything here, they state what the Petitioners urge, that is, the barrel per day figure is a "definition of a small producer" (subsequently entitled in the statute, "independent producers and royalty owners"), not a requirement of production concurrent with the bonus payment for a percentage depletion deduction.

Also the Government would use the same congressional debates to argue that the retention of percentage depletion for the defined group was to encourage further exploration (Gov't Br. 30). No one can dispute that premise, but this leaves the Government's argument with respect to the specific situation of a lease bonus against the congressional purpose. If the bonus is not eligible for percentage depletion there is no percentage

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[30] It is equally erroneous for the Court of Claims to give weight to the Government's proposed regulations (Prop. Treas. Reg. § 1.613A (1977)) inasmuch as "they carry no more weight than a position advanced on brief by the respondent [the Government]." *F. W. Woolworth Co.* v. *Commissioner*, 54 T.C. 1233, 1265-66 (1970). *Cf.* n.5, *supra*.

Similarly, with respect to the absence of weight to be accorded revenue rulings issued by the Government, *see United States* v. *Bennett*, 186 F.2d 407, 410 (5th Cir. 1951) (ruling of the Commissioner has "no more binding or legal force than the opinion of any other lawyer"); *Duquesne Warehouse Co.* v. *Railroad Retirement Bd.*, 148 F.2d 473, 477-78 (2d Cir. 1945), *rev'd on other grounds*, 326 U.S. 446 (1946); and *Fleming* v. *A. H. Belo Corp.*, 121 F.2d 207, 214 (5th Cir. 1941), *aff'd sub nom. Walling* v. *A. H. Belo Corp.*, 316 U.S. 624 (1942).

depletion incentive for the mineral owner to grant a lease. One may say that if no depletion is allowed, the lessee can simply pay a larger bonus so that the lessor would have the same amount of income after taxes, but such an argument goes against the congressional position that exploration is to be encouraged. The reason is that a lessee who must capitalize the bonus as lease cost[31] simply has less money to purchase leases and to drill thereon. This would be especially true as to those small producers whom percentage depletion is designed to help.[32]

D. THE GOVERNMENT'S POSITION IS INEQUITABLE TO A CLASS OF TAXPAYERS

Not only would the Government's position resurrect an anomaly laid to rest since *Herring* in 1934, but it would introduce a new inequity between taxpayers who opt for bonus payments and those that choose a larger royalty interest. As was shown above, a bonus payment is the economic equivalent of an advance royalty. Hence, to deny percentage depletion to the lessor who receives a bonus payment as consideration, in part, for a lease with respect to his mineral interest rather than an additional royalty is to treat differently two taxpayers who are otherwise similarly situated. For tax reasons a lessor of oil and gas property is forced toward an additional slice of royalty instead of a bonus because the former produces a larger deduction and thereby reduces taxable income.

But it is ironic in light of the congressional debate that the Government's position would penalize the less affluent royalty owner who would opt for the certainty of the bonus rather than a

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[31] *Canada River Gas Co.* v. *Higgins*, 151 F.2d 954 (2d Cir. 1945), *cert. denied*, 327 U.S. 793 (1946); Treas. Reg. § 1.612-3(a)(3) (1982).

[32] Compare the position of the Court of Claims as set forth in n.19, *supra*, where both lessor and the lessee would lose depletion.

larger royalty.[33] In most cases the only lessor who would demand the largest possible royalty and forego additional bonus would be that taxpayer who already had the assurance of substantial income.

E. IN THE ALTERNATIVE, PETITIONERS HAD ACTUAL EXTRACTION DURING THE YEAR 1976 AND THEREFORE COME WITHIN THE GOVERNMENT'S POSITION HERE

The discussion of the instant case thus far has focused upon the proper allowance of percentage depletion if there is no oil or gas production during the taxable year when the bonus payment is received. However, Petitioners' rights do not depend solely upon a favorable resolution of this issue because royalty oil and gas were actually produced on behalf of Petitioners during the year in which the bonus was received (Stip. para. 31, Exhibit K, J.A. 10, 42-46). The year at issue is 1976. In January, 1976 Petitioners received a bonus payment and during the subsequent months of 1976 oil and gas was produced from the same properties attributable to the bonus payment. Under the provisions of Section 613A(c)(2), Petitioners' average daily production of crude oil for 1976 from these particular properties is determined by dividing Petitioners' aggregate production of oil from these properties (and any other producing properties owned by Petitioners) by the number of days in the taxable year. Thus, during 1976 Petitioners' "average daily production" from these properties was *not* zero as the Government would have this Court believe (Gov't Br. 10, 33).

Hence, even if this Court determines that Section 613A should be interpreted to require "average daily production" during the year of the payment, Petitioners' bonuses qualify for percentage depletion under the facts in the instant case. The

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[33] *See, e.g.*, 121 CONG. REC. 4641 (1975) (remarks of Rep. de la Garza: "We are only hurting the little people" if Congress repeals percentage depletion for royalty owners).

amount of dollars paid to Petitioners (by the lessees) for this "average daily production" was the aggregate of the bonus *plus* Petitioners' 20% share (under the terms of the lease) of the sale proceeds of actual production during 1976. While the payment to Petitioners for royalty oil during 1976 would be more dollars per barrel than the oil's ordinary selling price, there is absolutely nothing to prohibit a lessee from purchasing royalty oil from a lessor for any price the two parties agree upon. Furthermore, Section 613A(c) imposes absolutely no restriction on the amount of dollars, the gross income, which can qualify for percentage depletion; the only limitation found in Section 613A(c) is upon a taxpayer's *volume* of production. Thus, even if this Court determines, as the Government urges, that Section 613A prohibits percentage depletion unless the taxpayer has "average daily production" during the taxable year, nevertheless, Petitioners in the instant case still qualify.

The Government's position in the *Engle* case (and, in an ambiguous manner, the Government's position before this Court) seems to agree with the above rationale. The Seventh Circuit in *Engle* interpreted the Government's position as allowing percentage depletion on payments made in advance of actual production so long as "one barrel of oil [is] produced from the leased properties during [the year of the payment]." *Engle* v. *Commissioner*, 677 F.2d at 600 (Pet. App. 27a). Under that interpretation of the Government's position, Petitioners' bonuses in the instant case qualify for percentage depletion. In its brief before this Court, however, the Government seems to have shifted its ground. Here, the Government argues that if one barrel of oil is produced during the year of the payment, the taxpayers are entitled to percentage depletion *but only on that one barrel* (Gov't Br. 24). Evidently, it is irrelevant to the Government whether the one barrel is produced before or after the bonus payment, so long as the barrel of oil is produced during the same taxable year as the bonus payment. Petitioners'

bonuses also qualify for percentage depletion under this revised Government theory. Petitioners' wells produced approximately 25,855 barrels of oil and 13,498,000 cubic feet of gas in 1976. For Petitioners' 20% share of this production, Petitioners were paid the advance royalty plus the actual production royalty. All of this amount qualifies for percentage depletion because Section 613A(c) places *no* limit on the amount of depletable *income* per barrel upon which percentage depletion may be claimed and no qualification on how or by whom such payment is made.[34]

Section 613A(c) simply imposes a volume limitation on Petitioner's right to percentage depletion under either the Government's interpretation, or an interpretation consistent with the established principles of this Court, the statute itself, and the legislative history.

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[34] *See* Bravenec, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 OIL & GAS TAX Q. 204, 212 (1975), cited favorably by the Government (Gov't Br. 20-21). This commentator agrees that if "production" in Section 613A means extraction as the Government here contends (his first of three possible constructions; *see* p. 10 n.13, *supra*), percentage depletion should be allowed on that bonus income. The difference between his position and that taken in this brief is that he would grant the percentage deduction in the years of production to which the bonus is spread. There is an obvious conceptual similarity between this approach and that discussed at pp. 12-16, *supra*.

Under his preferred ("second") approach, i.e., that "production" means "sales," depletion would be allowed when the bonus is received apparently regardless of when production occurs; he notes there is a "crucial determination" to be made in applying the volume limitation "which is capable of solution." *Id.* A solution is advanced at pp. 12-16, *supra*.

CONCLUSION

The volume limitation of Section 613A does not disallow the Petitioners' percentage depletion deductions on lease bonus income received in 1976 because (1) the allowance of such deductions is consistent with the long-standing decisions of this Court, the respective language and functions of the depletion sections of the Code and the relevant legislative history, and (2) in the alternative, the Petitioners in fact had production during 1976 sufficient to satisfy even the Government's interpretation of the statute sought here.

For these reasons, the judgment of the Court of Claims should be reversed.

Respectfully submitted.

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April 22, 1983

No. 82-774-CFX
Status: GRANTED

Title: Philip D. Farmar, et al., Petitioners
v.
United States

Docketed:
November 5, 1982

Court: United States Court of Appeals for
the Federal Circuit

Vide:
82-599

Counsel for petitioner: Collie, Marvin K.

Counsel for respondent: Solicitor General

Entry	Date	Note	Proceedings and Orders
1	Nov 5 1982	G	Petition for writ of certiorari filed.
2	Dec 7 1982		Brief of respondent United States in support of petition filed.
3	Dec 8 1982		DISTRIBUTED. January 7, 1983
4	Jan 10 1983		Petition GRANTED. The case is consolidated with No. 82-599 and a total of one hour is allotted for oral argument.
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7	Feb 23 1983		Order extending time to file joint appendix and government's opening brief on the merits until March 26, 1983.
8	Mar 3 1983		Record filed.
9	Mar 24 1983		Joint appendix filed.
10	Mar 28 1983		Brief of respondent United States filed. VIDED.
11	Apr 7 1983	G	Motion of respondents in No. 82-599 and petitioners in No. 82-774 for divided argument filed.
12	Apr 25 1983		Motion of respondents in No. 82-599 and petitioners in No. 82-774 for divided argument GRANTED.
13	Apr 22 1983		Brief of petitioner Philip D. Farmar, et al. filed.
14	Jul 8 1983		CIRCULATED.
15	Aug 15 1983		SET FOR ARGUMENT. Tuesday, October 11, 1983. (3rd case) This case is consolidated with No. 82-599. (1 hr.)
16	Sep 30 1983	X	Reply brief of petitioner CIR in 82-599 filed. VIDED.
17	Oct 11 1983		ARGUED.